THE PRIVATE EQUITY REVIEW

TENTH EDITION

Editor
Stephen L Ritchie

THE LAWREVIEWS

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Published in the United Kingdom
by Law Business Research Ltd, London
Meridian House, 34–35 Farringdon Street, London, EC4A 4HL, UK

www.TheLawReviews.co.uk

ISBN 978-1-83862-812-3

Printed in Great Britain by
Encompass Print Solutions, Derbyshire
Tel: 0844 2480 112

ACKNOWLEDGEMENTS

The publisher acknowledges and thanks the following for their assistance throughout the preparation of this book:

ALLEN & OVERY

ALTER LEGAL SL

BAHR

CUATRECASAS

FASKEN MARTINEAU DUMOULIN LLP

JINGTIAN & GONGCHENG

KIRKLAND & ELLIS

LEGANCE – AVVOCATI ASSOCIATI

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PREFACE

The tenth edition of *The Private Equity Review* follows a turbulent year for dealmakers in 2020. Uncertainties created by the global covid-19 pandemic triggered a significant slowdown in deal activity in the first and second quarters. However, a combination of central bank interventions, fiscal stimulus, optimism about a vaccine and better virus management led to frenetic third and, especially, fourth quarters. The net result was that the number and value of global buyouts increased significantly over 2019's already robust activity, while there was a noticeable decline in private equity exits. The year 2020 also saw a flurry of IPO and merger and acquisition activity by special purpose acquisition corporations, or SPACs, some formed by private equity sponsors and others formed by other dealmakers. Fundraising activity was also strong, notwithstanding the pandemic, with aggregate capital of nearly US$1 trillion raised, as institutional investors remained extremely interested in private equity as an asset class because of its continued strong performance. As a result, private equity funds have record amounts – by one estimate, nearly US$1.5 trillion – of available capital, or dry powder. PE funds' dry powder (and the need to deploy it), together with competition from SPACs, sovereign wealth funds, family offices and pension funds, led to very competitive transactions being completed at increasing leverage levels and purchase price multiples. This has caused private equity firms to become even more creative as they seek opportunities in less competitive markets or in industries where they have unique expertise.

The year 2020 showed once again the resilience of the private equity market and the creativity of private equity dealmakers. Given PE funds' creativity and available capital, we are confident that private equity will continue to play an important role in the global economy, not only in North America and Western Europe, but also in developing and emerging markets in Asia, South America, the Middle East and Africa, and to further expand its reach and influence, even in the face of potential political, regulatory and economic challenges.

Private equity professionals need practical and informed guidance from local practitioners about how to raise money and close deals in multiple jurisdictions. *The Private Equity Review* has been prepared with this need in mind. It contains contributions from leading private equity practitioners in 25 different countries, with observations and advice on private equity dealmaking and fundraising in their respective jurisdictions.

As private equity has grown, it has also faced increasing regulatory scrutiny throughout the world. Adding to this complexity, regulation of private equity is not uniform from country to country. As a result, the following chapters also include a brief discussion of these various regulatory regimes.

I want to thank everyone who contributed their time and labour to making this tenth edition of *The Private Equity Review* possible. Each of these contributors is a leader in their respective markets, so I appreciate that they have used their valuable and scarce time to share their expertise.

Stephen L Ritchie
Kirkland & Ellis LLP
Chicago, Illinois
March 2021

Part I

Fundraising

Chapter 1

AUSTRIA

Martin Abram and Clemens Philipp Schindler[1]

I GENERAL OVERVIEW

At the time of writing, no information was available about the fundraising market in 2020. The most recent information available is for 2019, for which the Austrian Venture Capital Association reported that Austrian private equity and venture capital funds raised €192 million, compared with €162 million in 2018 and €216 million in 2017.

The number and volume of Austrian private equity and venture capital funds continues to be well below the European average.

The announcement of the Austrian government in 2020 that it intends to implement a programme to provide incentives for private equity investment into start-ups and small and medium-sized enterprises (SMEs), which includes potential tax incentives as well as a new corporate form (akin to a Luxembourg SICAV) for alternative investment funds (AIFs), was not pursued mainly because of the covid-19 pandemic and its economic impact. As two major Austrian banks have announced their intention to set up AIFs to provide equity and debt financing primarily to Austrian SMEs to counteract the economic effects of the covid-19 pandemic, it is expected that this will provide new impetus to the Austrian government to actually implement the announced programme.

II LEGAL FRAMEWORK FOR FUNDRAISING

Since the introduction of the Alternative Investment Manager Act (AIFMG), which implements the Alternative Investment Fund Managers Directive,[2] most private equity funds established in Austria will qualify as AIFs under the AIFMG. An AIF is defined as a collective investment undertaking that raises capital from a number of investors to invest it in accordance with a defined investment policy for the benefit of those investors, and that does not use the capital for direct operational purposes. Funds pursuant to the Austrian Investment Funds Act as well as funds qualifying under the Austrian Real Estate Investment Funds Act are not captured by the AIFMG.

The formation of an AIF requires the prior approval of the Austrian Financial Market Authority (FMA) if the fund is managed by a licensed alternative investment fund manager (AIFM). If the fund is managed by a registered AIFM, it only has to be registered with

1 Martin Abram and Clemens Philipp Schindler are partners at Schindler Attorneys.

2 Directive 2011/61/EU on alternative investment fund managers, as amended.

the FMA. AIFMs must obtain a licence if they manage funds with assets of more than €100 million (where leverage is used) or more than €500 million (where no leverage is used); otherwise, only a registration is required.

To obtain a licence under the AIFMG, the manager must fulfil the following requirements.

a A licensed AIFM must have minimum capital of €125,000 if it is an external manager of an AIF. If the AIFM is an internal manager of an AIF, the minimum capital requirement is €300,000. In addition, the AIFM must have sufficient equity to cover 25 per cent of its annual running costs. Increased equity requirements apply if the assets under management exceed €250 million; in any case, the maximum capital requirement is €10 million. The persons tasked with the management of the AIFM must be sufficiently experienced, and have to pass a 'fit-and-proper' test if so requested by the FMA.

b The AIFM has to appoint at least two individual persons as its managers.

c In the application to the FMA, the AIFM must provide information on shareholders holding qualified participations in the AIFM (i.e., shareholdings exceeding 10 per cent), on any closely related entities (i.e., a third party that holds a stake of more than 20 per cent of the AIFM or that controls the AIFM, or is controlled by the AIFM or in which the AIFM holds a stake of more than 20 per cent), its business plan, its remuneration, risk management, valuation, internal audit and conflict of interest policies, its investment strategies, a description of any competences delegated to third parties and information on the contractual basis pursuant to which it manages its AIFs.

The decision of the FMA regarding the licensing of an AIFM has to be made within three months of the applicant providing all required information. If the AIFM intends to register an AIF as a European long-term investment fund (ELTIF) (see Section II.vi), he or she has to apply to the FMA for prior approval.

i Vehicles used for private equity funds

The main vehicles used for private equity funds established in Austria are limited partnerships (LPs), typically with a corporation as the general partner, or corporations, namely limited liability companies (LLCs) and joint-stock companies (JSCs). Each of these types of entity has a separate legal personality, but partnerships are transparent for tax purposes.

LPs

Typically, investors become limited partners in an LP. The general partner is usually an LLC that receives a fee for assuming unlimited liability. In some structures, the general partner manages the partnership; in other structures, a separate management company (usually an LLC) manages the partnership. As private equity funds in most cases fall under the AIFMG, the entity managing the fund must be a legal person licensed or registered as an AIFM under the AIFMG. There are generally no minimum capital requirements for newly incorporated LPs.

Corporations

Investors become shareholders in an LLC or a JSC. An LLC is managed by a managing director; a JSC by a managing board. JSCs (as opposed to LLCs) are required by law to also have a supervisory board. Managing directors, as well as members of the managing board, have to be natural persons. However, as with LPs, corporations can outsource management functions to a management company, which in most cases must be licensed or registered as an AIFM under the AIFMG. Austrian law has minimum share capital requirements for LLCs (€35,000, or €10,000 in the case of a privileged incorporation) and JSCs (€70,000).

In the past, sponsors also structured vehicles in the form of LLCs or JSCs as a medium-sized business financing company (MFG) under the Corporate Income Tax Act (KStG), as this gave rise to several tax benefits. MFGs had to fulfil certain requirements, such as higher capitalisation, participation of public bodies and certain investment restrictions. As those tax benefits no longer apply for vehicles founded after 2012 and ceased to apply in respect of participations held by existing MFGs (founded before 2012) by the end of 2015 (in special circumstances, by the end of 2018), the importance of the MFG has decreased significantly. The tax benefits for MFGs were reintroduced in 2017; however, only to a limited extent. In particular, the tax benefits only apply for minority investments in early-stage enterprises.

ii Key legal terms

In addition to terms imposed by mandatory provisions of Austrian law, in particular the investor protection provisions of the AIFMG for private equity funds classified as AIFs, the key terms of the relationship between the investor and the fund are governed by the partnership agreement (for LPs) or the articles of association and shareholders' agreements (for LLCs and JSCs). Terms of a private equity fund typically subject to negotiation include:

a investment restrictions, such as target size, concentration limits, geographic limitations, diversification of industries, limits on borrowing and related-party transaction restrictions;
b limitations on the fund's size and the investors' capital commitments;
c investment period;
d key-man provisions;
e provisions permitting the removal of the manager by a qualified majority of investors;
f remuneration of the manager (i.e., management fee, investment-related fees and carried interest);
g reinvestments; and
h exclusivity.

iii Disclosure of information

In recent years, Austria has seen an increasing number of court proceedings by private investors against managers and promoters of funds to recover losses suffered during the financial crises. These proceedings highlight the importance of full disclosure to investors at the time they invest in a fund.

Managers of funds have to ensure that all documents given to investors, in particular the offering documentation and all advertising material, disclose all facts and circumstances relevant to prospective investors fully and correctly. Additionally, special care should be taken that any opinions and plans disclosed to investors are reasonable and based on verifiable facts. Special care must also be taken to ensure that the wording of documents is not too complicated or technical, otherwise there is a risk that this could be seen as insufficient disclosure. Austrian courts do, by and large, take into account the types of investors to which such offering documentation is addressed, and may take a less restrictive position in cases where an offer is solely addressed to institutional investors (as opposed to offers addressed to retail investors).

In the case of insufficient disclosure, managers are faced primarily with damage claims, rescission claims, or a combination of both by investors; additionally, regulatory sanctions and – in extreme cases – criminal sanctions may apply.

The key items for disclosure vary depending on whether the offer of the fund interest falls under the scope of the Austrian Capital Markets Act or the EU Prospectus Regulation. Typically, the main items for disclosure are:

a investment strategy;
b market overview and regulatory environment;
c key terms of the investment (see above);
d risk factors;
e track record of the manager and its executives; and
f tax matters.

Whether an offer of interests in a private equity fund falls under the scope of the Austrian Capital Markets Act or the EU Prospectus Regulation depends on the type of interest offered. For securities, the EU Prospectus Regulation applies, and thus – if no private placement exemption applies – a prospectus complying with the EU prospectus regime has to be prepared. If the interest are not securities (such as partnership interests or shares in Austrian limited liability companies), the offer falls under the scope of the Austrian Capital Markets Act. In this case and if no private placement exemption applies, the issuer has to prepare a prospectus complying with the regime of the Austrian Capital Markets Act, except for offers encompassing fund interests with a total value of (1) less than €5 million during a 12-month period, in which case a simplified prospectus can be used or (2) less than €2 million during a 12-month period, in which case the disclosure obligations of the Alternative Financing Act apply.

iv Solicitation

The method of solicitation is mainly influenced by regulatory constraints. Most commonly, solicitation is made by way of an information or offering memorandum. Potential key investors are typically contacted at an early stage to gauge their initial interest. Unless there are regulatory constraints (such as in the case of public offers falling under the scope of the Austrian Capital Markets Act or the EU Prospectus Regulation), investors are invited to follow-up meetings or given the opportunity for a limited due diligence. Depending on the size of the fundraising, managers may also appoint third-party promoters to assist in identifying potential investors; in addition, outside counsel is retained to prepare the documentation for the fundraising.

Limitations on solicitation

Offers and sales of interests in private equity funds formed in Austria are subject to the following selling restrictions, which depend on the category of the private equity fund.

For AIFs managed by a licensed AIFM:

a interests in the fund may only be offered or sold after the AIF is approved by the FMA; and *b* interests in the fund may be offered or sold to private investors, if the prerequisites of Sections 48 and 49 AIFMG are met, except if the fund is registered (1) as a European venture capital fund (EuVECA) (see Section II.v); in this case, it may be offered to private investors subject to certain restrictions (in particular, a minimum investment commitment of €100,000 and a written acknowledgment of the risks associated with the investment by the private investor) or (2) as an ELTIF (see Section II.vi); in this case, it may be offered to private investors subject to certain restrictions (in particular, an offer is only possible to private investors having an investment portfolio of at least €100,000 after the investor has received appropriate investment advice).

For AIFs managed by a registered AIFM:

a interests in the fund may only be offered after the AIF was notified to the FMA; and

b interests in the fund may not be offered or sold to private investors, except if the fund is registered as an EuVECA; in this case, it may be offered to private investors subject to certain restrictions (in particular, a minimum investment commitment of €100,000 and a written acknowledgment of the risks associated with the investment by the private investor). No ELTIF registration is available for funds managed by registered AIFMs.

For private equity funds falling outside the AIFMG:

a any public offer of interests in private equity funds falling outside the AIFMG requires the publication or approval, or both, of a prospectus by the FMA, unless a private placement exemption applies;

b the private placement exemption applies, in particular, for offers to qualified investors only, offers with a minimum investment amount of €100,000, and offers to fewer than 150 investors; and

c even if the private placement exemption applies, the intended offer has to be notified to the issue register maintained by Oesterreichische Kontrollbank AG.

v EuVECA Regulation

The EuVECA Regulation[3] was introduced to create a new pan-European designation for small AIFMs, the EuVECA. Austria-based AIFMs may register an AIF as a EuVECA provided that they comply with the EuVECA Regulation and have supplied certain information with regard to themselves and the relevant AIF to the FMA. The main advantage the AIFM gains by doing so is the option to market the relevant AIF throughout the EU under the EuVECA designation to certain categories of investors defined in the EuVECA Regulation under an EU-wide passporting regime. Passporting allows a firm authorised under an EU single market directive to market the designated fund to certain qualified investors in another EU Member State, on the basis of its home state authorisation.

The EuVECA Regulation is not compulsory; if an AIFM does not want to use the EuVECA designation, then it does not have to comply with the EuVECA Regulation for a particular fund (or at all). If the AIFM chooses not to use the EuVECA designation, national laws and EU regulations apply, such as national private placement regimes.

3 Regulation (EU) No. 345/2013 on European venture capital funds.

vi ELTIF Regulation

The ELTIF Regulation[4] was introduced in November 2015 to channel capital raised through AIFs towards European long-term investments in the real economy. Austria-based AIFMs who have received approval to manage ELTIFs may register an EU-based AIF (or a compartment thereof) as an ELTIF, provided that they comply with the authorisation requirements set out in the ELTIF Regulation and submit an application to the FMA. The main advantage of such a registration is the option to market the relevant AIF throughout the EU under an EU-wide passporting regime similar to the regime under the EuVECA Regulation. Additionally, the designation of an AIF as an ELTIF allows its marketing to high-net-worth individuals throughout the EU.

The ELTIF Regulation is not compulsory; if an AIFM does not want to use the ELTIF designation, it does not have to comply with the ELTIF Regulation for a particular fund (or at all). If the AIFM chooses not to use the ELTIF designation, national laws and EU regulations, such as national private placement regimes, apply.

vii Fiduciary duties to the investors

Typically, the scope of the sponsor's fiduciary duties is determined by the AIFMG (which most private equity funds fall under), the constitutional documents of the fund vehicle (supplemented by pertinent rules of law) and other contractual arrangements (if any).

Under the AIFMG, the manager has, inter alia, to act in the best interests of the investors in the AIF (as well as of the AIF itself) and the integrity of the market. The manager has to introduce appropriate procedures to deal with conflicts of interest, to treat the investors in an AIF fairly and to use the required diligence in the performance of his or her duties.

Managers of Austrian private equity funds are most frequently general partners of an LP or fulfil their function based on management agreements with the fund vehicle. Thus, the scope of the managers' duties and the extent of their liability in relation to the investors (and the fund vehicle) derive from the partnership agreement (supplemented by the mandatory provisions of the Commercial Code) or, as the case may be, the management agreement.

Unless the private equity fund is an AIF, it is possible to limit the liability of the sponsor in relation to the investors or limit the liability of the fund vehicle by contractual provisions (e.g., to exclude liability for 'ordinary negligence'). However, such contractual provisions would still be subject to judicial review.

III REGULATORY DEVELOPMENTS

Private equity funds established as AIFs and their managers are subject to the ongoing supervision of the FMA. The FMA has a wide range of inspection and audit rights with respect to both the AIFM and the individual AIFs.

Austrian law distinguishes between AIFMs that require licensing by the FMA and AIFMs that only have to register with the FMA. Licensed AIFMs do not require any additional licences for their management activities for the fund. Registered AIFMs may require a business permit for asset managers.

Investors holding qualified participations in the AIFM (i.e., shareholdings exceeding 10 per cent) must be disclosed to the FMA, but only by licensed AIFMs.

4 Regulation (EU) No. 760/2015 on European long-term investment funds.

Private equity funds established as AIFs must be registered with the FMA. Private equity funds established as AIFs and managed by a licensed AIFM also require approval by the FMA. Austrian AIFs are also listed in an informal register maintained by the FMA.

Private equity funds not established as AIFs require no special registration, except for the registration with the Companies Register upon incorporation.

If the sponsor also acts as the manager of a fund established as an AIF, it has to be registered or, as the case may be, licensed with the FMA. In addition, if the sponsor holds a qualified participation in the fund, this fact has to be disclosed to the FMA.

Otherwise, no specific licence requirements exist for the sponsors of a fund.

Taxation

Taxation of the fund

The most common private equity fund vehicle in Austria is a partnership. Different from corporations, Austrian partnerships are typically viewed as transparent for tax purposes, provided that the partnership's sole activity qualifies as asset management for tax purposes, and it is not deemed to operate a business or commercial operation.

Any income derived by the partnership is allocated to its investors and taxed at their level in accordance with the rules of the tax regime applicable to the individual investor.

Since 1 January 2016, Austria has not levied capital duty on equity contributions. However, stamp duty, in particular in relation to guarantees that the formation documentation may entail, is still an area to be considered. In this context, surety agreements (including any form of assumption of a debt as joint debtor) are subject to stamp duty at a rate of 1 per cent of the secured amount provided that the surety is of an accessory nature, which means that the guarantor may avail itself not only of all defences that it personally has against the creditor, but also of all defences that the debtors of the secured debt have against the creditors. However, if the guarantee is of an abstract nature, meaning that the guarantor has to pay upon first demand and has recourse only to those defences that arise from the guarantee itself, then the transaction is not subject to stamp duty. Therefore, guarantee wordings explicitly stating that a specific guarantee is intended as an abstract are commonly used.

Taxation of investors

Domestic individual investors are taxed as follows: capital gains are subject to a preferred tax rate of 27.5 per cent; and dividends are subject to withholding tax at a rate of 27.5 per cent.

Domestic corporate investors are taxed as follows: capital gains are taxed at a rate of 25 per cent if they relate to an Austrian-resident portfolio company, and may be tax-exempt if they relate to a foreign-resident portfolio company in which a minimum shareholding of 10 per cent is (indirectly) held for an uninterrupted period of at least one year (Section 10, KStG); and dividends are tax-exempt if they relate to an Austrian-resident portfolio company or an EU-resident portfolio company, and may be tax-exempt under certain conditions if they relate to another foreign portfolio company (Section 10, KStG). On 1 January 2019, new provisions in connection with international participations and foreign portfolio shareholdings came into force, along with new controlled foreign corporation taxation rules.

Foreign individual investors are taxed as follows: capital gains are only taxable (at a rate of 27.5 per cent) if the percentage of the investor's (weighted) shareholding in the Austrian portfolio company (through the partnership) exceeded 1 per cent at any time during the past five years. Note that double-tax treaties usually restrict Austria's right to tax such capital gains (Article 13, Paragraph 5 of the Organisation for Economic Co-operation and Development

Model Tax Convention on Income and on Capital (MTC)); and dividends are subject to withholding tax at a rate of 27.5 per cent (as of 1 January 2016) (subject to a reduction under applicable double tax treaties).

Foreign corporate investors are taxed as follows: capital gains are only taxable (at a rate of 25 per cent) if the percentage of the investor's (weighted) shareholding in the Austrian portfolio company (through the partnership) exceeded 1 per cent at any time during the past five years. Double-tax treaties usually restrict Austria's right to tax such capital gains (Article 13, Paragraph 5, MTC); and dividends are subject to withholding tax at a rate of 25 per cent in cases where the exemption for foreign investors that are corporations resident in an EU Member State is not applicable (but will usually be subject to a reduction under applicable double tax treaties).

Taxation of carried interest

Carried interest, which is defined as the compensation of a partner of an asset management partnership received because of outstanding contributions to the successful management of the investments, is included in the investment income according to the Department of International Taxation of the Ministry of Finance.[5] Income qualifying as investment income received by an individual who is subject to unlimited taxation in Austria is taxable in Austria with the special tax rate of 27.5 per cent. Despite this administrative guideline, a case-by-case analysis is recommended, as the line between self-employed and employee income and investment income is rather unclear.

The management fees received by a partner of an asset management partnership are not subject to VAT. According to the Austrian tax authorities, the managing partner of a partnership is not an entrepreneur; his or her services are supplied in the exercise of a corporate function, and not as a result of an exchange of services. If the fund vehicle is a corporation, however, the fees of a managing partner will usually be subject to VAT, unless the manager is employed by the corporation.

IV OUTLOOK

Fundraising by Austria-based private equity remains low compared to other European countries. However, two of the main Austrian banks have announced the setting up of AIFs to provide equity and debt financing primarily to Austrian SMEs to counteract the economic effects of the covid-19 pandemic.

It remains to be seen whether this announcement will lead the Austrian government to introduce legislation to provide incentives for private equity investment SMEs, as it previously announced on several occasions.

5 EAS 3280 as of 14 May 2012, EAS 2698 as of 6 February 2006 and BMF 15 December 2008 (BMF 010221/3364-IV/4/2008).

Chapter 2

CANADA

Jonathan Halwagi, Tracy Hooey, Anabel Quessy and Ryan Rabinovitch[1]

I GENERAL OVERVIEW[2]

The volatile markets and uncertainty resulting from the covid-19 pandemic undeniably impacted Canadian private equity fundraising in Canada. However, contrary to the United States where it was reported that closings fell 39 per cent in the first quarter of 2020 from the prior quarter, and commitments were down 37 per cent because of the volatile markets in the same time period,[3] it seems, if we base ourselves on the attitude of pension plans and other industry participants, that the impacts across the border in Canada were not as severe.

The delayed impact of the pandemic on private equity fundraising in Canada may be a result of government stimulus. More specifically, the government of Canada has taken measures to support Canadian businesses facing hardship as a result of the covid-19 outbreak. The government implemented interest-free loans, rent subsidies, loan guaranties, co-lending programmes, relief and recovery funds, financing programmes and large employer financing facilities.[4] While these programmes continue to fund and support businesses, it may prove difficult to realistically assess the impact that covid-19 has had over private equity fundraising in Canada.

Nevertheless, the current pandemic and the reaction from governments, institutional investors and public markets have created a turbulent economic environment where otherwise performing assets have faced short-term pressure, and as a response, the current market is buzzing with high net worth and institutional investors looking for investments in distressed or opportunistic funds across different asset classes, including private equity.

As a consequence, several opportunistic funds were launched in Canada in 2020, including the National Bank SME Growth Fund, LP, a C$200 million fund established in partnership between National Bank and the Quebec government aiming to support Quebec's economic recovery following the covid-19 pandemic and the digital transformation of SMEs.

1 Jonathan Halwagi, Tracy Hooey, Anabel Quessy and Ryan Rabinovitch are partners at Fasken Martineau DuMoulin LLP.

2 This section is based on industry reports available in January 2021. Private equity or venture capital firms in Canada are not required to report their activities; consequently, the industry reports reflect verifiable information only and may not adequately reflect the activities of all private equity or venture capital firms.

3 Gary Robertson, 'Pandemic Puts a Pause on Private Equity' (25 May 2020), online: *Callan* www.callan.com/blog-archive/1q20-private-equity/.

4 Government of Canada, 'Canada's COVID-19 Economic Response Plan' (last modification on 5 January 2021), online: *Government of Canada* www.canada.ca/en/department-finance/economic-response-plan.html.

In addition, Novacap Investments, Inc launched Novacap Financial Services I, LP with a target size of C$456 million and Brightspark Capital Inc launched the Brightspark Canadian Opportunities Fund with a target size of C$75 million.

II LEGAL FRAMEWORK FOR FUNDRAISING

Common legal structure and key terms

Legal vehicle

As with most other jurisdictions, the selection of the legal structure for private equity funds is driven by tax considerations and liability protection for investors. The most common legal structure used for private equity funds in Canada is the limited partnership as it provides tax transparency (as discussed in Section III.ii) and limited liability to investors.

In Canada, limited partnerships can be established pursuant to the laws applicable in any of Canada's provinces and territories. The legal regime applicable to limited partnerships is generally similar across all Canadian jurisdictions, providing limited liability to investors who do not take an active part in the business of the limited partnership and providing a flow-through tax treatment to its partners.

Each Canadian jurisdiction expresses the concept of not taking an active part in the business of the partnership slightly differently. In Ontario, the Limited Partnership Act (Ontario) provides that a limited partner is not liable as a general partner unless the limited partner 'takes part in the control of the business'.[5] In Manitoba, the Canadian jurisdiction that is generally viewed as offering the widest protection to limited partners, the Partnership Act (Manitoba) provides that the loss of limited liability by a limited partner is caused by the limited partner taking 'an active part in the business of the partnership'.[6] However, unlike other Canadian jurisdictions, the limited liability of the limited partner is not lost with regard to any person who knew that the investor was a limited partner.[7]

Notwithstanding the above, private equity managers typically establish the fund under the laws of the province where they are established and conduct most of their activities. However, other considerations or pressures may come into play when deciding where to establish the fund in Canada. Key anchor investors may pressure the private equity managers to establish the fund in a jurisdiction they are more familiar with[8] or that provides slightly more advantageous language with regard to the limited liability of investors (such as Manitoba, for example, as described above).

5 See Section 13(1) of the Limited Partnership Act (Ontario), R.S.O. 1990, c. L.16.
6 See Sections 63(1) and 63(2) of the Partnership Act (Manitoba), C.C.S.M., c. P30.
7 ibid.
8 While there is often no specific tax advantage to doing so, when marketing to non-Canadian investors, Canadian private equity managers sometimes choose to establish their funds in offshore jurisdictions that are more familiar to the non-Canadian investors (e.g., the Cayman Islands).

Constituting document

The constituting document used to govern a limited partnership is the limited partnership agreement. The limited partnership agreement provides the terms of the fund, including the fund's investment objectives and restrictions, the duties and powers of the general partner and the limited partners, the capital call and distribution mechanisms and the fund's term, termination and liquidation.

While the specific terms of Canadian private equity funds can vary, the terms of larger funds are usually aligned with the prevailing market practice for similar funds established in larger jurisdictions (especially the United States and the United Kingdom). We discuss some of the key terms below.

Life of the fund

Private equity funds in Canada are traditionally established as closed-ended funds. The limited partnership agreement usually provides for an offering period of 12 to 18 months from the initial closing of the fund during which new or existing investors can make new capital commitments to the fund. After the offering period has ended, the fund is no longer open to new capital commitments.

The fund's life is divided into two phases – the investment period and the management period. During the investment period, which usually ranges from three to five years from the initial closing of the fund, the private equity manager deploys the capital committed by the limited partners by making portfolio investments. Thereafter, during the management period, subject to exceptions, the fund is generally not permitted to make further capital calls for investment purposes. During the management period, the general partner manages the portfolio investments, eventually finding exit opportunities to liquidate the portfolio. The management period usually ranges between four and seven years from the end of the investment period.

A recent trend has seen the establishment of evergreen private equity funds. Unlike the traditional closed-ended funds, evergreen funds do not have a pre-established fund life and are able to raise additional capital commitments on an ongoing basis.

Investment policy, investment restrictions

The fund's investment objectives, investment strategy and investment restrictions are often detailed in the limited partnership agreement or in one of its schedules.

Common restrictions often include limits regarding the jurisdictions in which investments can be made in, the maximum and minimum size of an investment, the amount of permitted indebtedness and restrictions related to the use of derivatives.

Governance

In terms of governance, Canadian private equity funds usually provide for the establishment of an advisory committee. Typically, limited partners having made capital commitments beyond an established threshold are given the right to appoint members of the advisory committee. At a minimum, the limited partnership agreement usually requires that the advisory committee review any proposed related-party transactions and provide guidance on other issues brought to it by the general partner.

Some Canadian private equity funds also provide a right to limited partners to remove and replace the general partner. While general partner removal provisions are not uncommon, their specific terms are by no means standard as they are heavily negotiated.

Management fees

Management fees are usually paid to the general partner (or the asset manager appointed by the general partner) in consideration for its management services. Management fees generally range from 1 per cent to 2 per cent of the aggregate commitments during the investment period and from 1 per cent to 2 per cent of the acquisition cost of portfolio investments after the investment period.

Organisational and offering expenses, operating expenses and general partner expenses

The limited partnership agreement also sets out who is responsible for assuming the various expenses incurred by the fund or by the general partner on behalf of the fund. These are often separated into three categories – organisational expenses, operating expenses and general partner expenses.

Organisational and offering expenses cover the establishment and organisation of the fund and the offering, sale and issuance of the interests of the fund. These expenses may include travel and accommodation expenses, and any expenses incurred in connection with the preparation of offering documents (including legal, accounting and filing fees). These expenses are generally borne by the fund up to a cap set by the limited partnership agreement. As a rule of thumb, the cap is usually set at not more than 1 per cent of aggregate commitments to the fund. Any organisational and offering expenses incurred above this cap are borne by the general partner.

Operating expenses cover, notably, all administration costs and expenses (e.g., legal, auditing, consulting, accounting, reporting, bookkeeping, financial, tax, insurance, valuation, contractor and custodial), expenses arising out of the contemplated or realised acquisition, holding, or sale of portfolio investments, and all extraordinary expenses, such as expenses relating to dispute resolution or damages. These expenses are also generally borne by the fund.

General partner expenses, which are commonly borne by the general partner, cover all expenses incurred for the operation and affairs of the general partner (e.g., costs of salaries, rent, fees incurred to promote the fund and to participate in networking events and other fees of the general partner that are not related to the fund).

Carried interest distributions

In addition to the management fees, the general partner (or an entity determined by the general partner) is usually entitled to receive carried interest distributions if distributions made to limited partners exceed their invested capital plus a preferred return (which typically ranges between 5 and 8 per cent). The carried interest distribution usually ranges between 15 and 20 per cent of distributions made beyond the preferred return threshold.

Standard of care

Most of the Canadian jurisdictions do not provide for a statutory standard of care for the general partner in their partnership laws. As such, many partnership agreements include a specific provision providing that the general partner discharge its duties diligently, in good faith and in the best interest of the fund.

Other key documents

Subscription agreement

Investors typically become limited partners by entering into a subscription agreement that sets out the amount of capital the investor is committing for investment in the fund, which is drawn down over time. The subscription agreement also contains representations, warranties and acknowledgements of the investor, notably relating to the accredited investor private placement exemption, residence and tax status of the investor. Investors that are individuals may be required to complete additional documents or will have a specific subscription agreement.

Management agreement

The general partner may delegate its powers to a manager either directly in the limited partnership agreement or in a separate management agreement. The management agreement typically addresses the powers being delegated to the manager, the management fees or other incentive consideration, including carried interest, and indemnification of the manager by the fund.

Marketing documents

One or more of the following documents is usually used to market a private equity fund in Canada – the offering memorandum, the term sheet and the marketing presentation.

The offering memorandum[9] is a marketing document purporting to describe the business and affairs of a fund that is prepared primarily for delivery to and review by prospective investors so as to assist them in making an investment decision in respect of an investment in the fund. It generally includes a description of the offering, the key terms of the fund (including its investment objectives, strategies and restrictions), a description of the business case supporting the fund's strategy and the risks associated with an investment in the fund. The laws of some of the Canadian jurisdictions provide statutory rights of rescission or damages, or both, to investors if an offering memorandum or one of its amendments contains a misrepresentation, provided these remedies are exercised within the time limits prescribed in each jurisdiction. These laws also generally require that the offering memorandum contain a description of these rights.

The term sheet is a summary of the key legal terms of the fund. A full version of the term sheet is normally included in the offering memorandum, but the term sheet can be used as a stand-alone marketing document, especially if an offering memorandum is not prepared in connection with the distribution of the fund. In some Canadian jurisdictions, term sheets or marketing presentations may be considered 'offering memoranda' and as such, may be subject to the statutory rights of rescission described above, including the requirement to include a description of these rights.

Side letters

It is not uncommon for private equity fund managers to provide certain investors with certain rights or preferential treatment by entering into side letter agreements with the investors. The provisions of such side letters alter the terms of the limited partnership agreement between

9 Offering memorandums are also commonly referred to as private placement memorandums and confidential information memorandum.

the investors and the general partner. As the side letter is not enforceable against the other limited partners, to be included in a side letter, the provision must not affect the other investors. Examples of rights that are often included in side letters include lower management fees, advisory committee membership, co-investment rights, specific disclosure rights, excuse or exclusion rights from fund investments and most favoured nation provisions.

III REGULATORY DEVELOPMENTS

i Regulatory requirements

From a regulatory perspective, there are two aspects that are important to consider when establishing and distributing private equity funds in Canada – the prospectus requirement and the registration requirements.

The prospectus requirement

In Canada, the issuance of interests in a private equity fund, whether the interests are unitised or not, is considered a distribution of securities.

The securities laws applicable in the Canadian jurisdictions prohibit the distribution of securities unless a prospectus has been filed and receipted by the applicable securities regulatory authority or the fund is otherwise exempt from this prospectus requirement.

The most common exemption from this requirement used by private equity funds is the private issuer exemption. Pursuant to the private issuer exemption, the prospectus requirement does not apply to a distribution of a security of a private issuer if the distribution of securities is made to an investor who subscribes to the security as a principal and is an accredited investor.

A closed-ended private equity fund will generally be considered a private issuer as long as it invests for the purpose of being actively involved in the management of the portfolio entities in which it invests, has restrictions on the transfer of its securities and as long as its securities are held by no more than 50 persons.

Accredited investors are investors that have the required sophistication to understand the risks relating to their investment and can financially bear the risk of losses relating to their investment. The list of accredited investors includes financial institutions, pension funds, government entities, trust companies, investment funds or accounts managed by registered advisers and high-net-worth persons.

Canadian regulatory authorities require that the fund take some steps to confirm the investor can rely on this prospectus exemption.

To the extent that the private issuer exemption is not available for use, the fund may rely on other available exemptions, including one for issuance of securities to accredited investors generally. This requires the filing of a report of an exempt trade.

The registration requirements

Canadian securities laws require that a person not engage in the business of trading in securities unless that person is registered as a dealer; not engage in the business of providing advice with respect to investing in securities unless that person is registered as an adviser; and not act as an investment fund manager unless the person is registered as an investment fund manager.

With regard to private equity funds, the Canadian regulatory authorities have issued guidance that provides that a typical closed-ended private equity fund, its general partner and its asset manager would generally not be required to register as dealers, advisers or investment fund managers as long as (1) the advice provided by the general partner (or the asset manager) in connection with the purchase and sale of portfolio entities is incidental to their active management of these portfolio entities; (2) both the raising of money from investors and the investing of that money by the fund are occasional and uncompensated; and (3) the fund invests for the purpose of being actively involved in the management of the portfolio entities in which it invests. Examples of active management in a portfolio entity include the general partner (or the asset manager) having representation on the board of directors or a say in material management decisions.

Most Canadian private equity funds fit within the scope of this guidance and, as such, are not investment funds for securities law purposes and are not required to be registered to conduct their activities.

ii Canadian taxation overview

Because private equity funds are typically structured as limited partnerships in Canada, the following is a general overview of the tax implications of such a structure for the funds and its investors.

Fund and Canadian investors

Limited partnerships are generally not subject to Canadian federal income tax. Rather, the general partner calculates the limited partnership's income and losses for each fiscal period and allocates them to the partners. The partners are then required to report their share of income or losses on their income tax returns. Particular sources of income and losses of the limited partnership, including capital gains and capital losses, retain their character when allocated to the partners. Consequently, the limited partnership is transparent for tax purposes and its partners are treated as though they had incurred any income or losses directly.

However, certain limited partnerships are not fiscally transparent. For example, specified investment flow-through tax (SIFT) partnerships may be taxed on some categories of Canadian income, including capital gains. A partnership may be a SIFT partnership if its investments are, or become, listed or traded on a public market.

Non-resident investors

When structuring a Canadian fund that may be offered to investors who do not reside in Canada, managers may want to consider blocking strategies to minimise Canadian tax reporting and tax leakage.

While a non-resident investor in a Canadian fund will generally not be subject to Canadian federal income tax on its share of income from a business carried on by the fund outside Canada, it may notably incur taxes as a result of capital gains resulting from the disposition of 'taxable Canadian property' (TCP) by the fund, or from the disposition of an interest in the fund, if it qualifies as TCP. The following may constitute TCP: Canadian real or resource property; assets used in carrying on a business in Canada; and interests in entities that, at any time in the five-year period preceding the disposition, directly or indirectly derived more than 50 per cent of their value from Canadian real or resource property.

In addition, a limited partnership with limited partners who are non-residents of Canada will be deemed to be a non-resident person for the purposes of Canadian withholding tax. Subject to reductions under an applicable income tax treaty, the withholding rate tax is

25 per cent of the gross amount of the payment. Accordingly, a non-resident investor in a Canadian fund will be subject to Canadian withholding tax on certain Canadian-source non-business income, including dividends and certain types of interests.

Value added tax

Value added tax may be imposed in Canada. More specifically, a federal component (goods and services tax (GST)) is applied at a 5 per cent rate, while a provincial component may be applied at an 8 per cent or 10 per cent rate depending on the province (collectively with the GST, harmonised sales tax (HST)).

Generally, HST must be paid by private equity funds structured as limited partnerships investing in shares or debt, and typically this tax may not be recovered by way of input tax credits. Distributions to a partner in consideration for its activities as a partner, however, are generally not subject to HST. For this reason, in some cases, a fund's general partner as opposed to a third-party manager, would carry out the management activities, and would receive a priority distribution in lieu of a management fee (since such a fee would generally have been subject to unrecoverable HST). To address this planning, legislation was enacted in December 2018 to impose HST on the fair market value of management services provided to certain funds by their general partner. The legislation applies to 'investment limited partnerships' (very generally, limited partnerships whose assets consist primarily of financial instruments such as shares, debt, trust units or other partnership interests).

In addition to the above, certain rules that apply to most investment funds impose HST on the basis of the residence of a fund's investors. However, most funds structured as limited partnerships were not subject to these allocation rules. To address this issue, legislation was enacted in December 2018 to extend the scope of the allocation rules to funds structured as limited partnerships as of 2019.

IV OUTLOOK

Like in other markets, environmental, social, and governance (ESG) principles have become increasingly important for Canadian fund managers as a result of growing demand from institutional investors seeking exposure to ESG-committed funds. Notably, Brookfield Asset Management, a Canadian fund manager, has become the second largest ESG-committed private capital fund manager globally. [10]

In addition, as previously mentioned, one of the most interesting recent trends in private equity fundraising is the emergence of evergreen private equity funds. Unlike their closed-ended counterparts, evergreen funds do not have a set life and continue until terminated.

This trend is driven both by the desire of managers to have permanent vehicles to manage and pressure from institutional investors who espouse a longer-term investment objective and do not want to be tied to a closed-ended investment cycle. Institutional investors are also attracted by the asset diversification provided by existing evergreen funds.

10 Prequin, 'Prequin Impact Report: The Rise of ESG in Alternative Assets' (November 2020) on p. 14, online (pdf): *Prequin* http://bit.ly/2Ly78p4.

Rather than committing capital to a new structure, an institutional investor committing to an existing evergreen fund can expect, when its capital is called, to participate in the assets already held by that evergreen fund.

The terms of evergreen funds are a hybrid of the terms of traditional closed-ended private equity funds and open-ended funds (mutual funds, hedge funds). In evergreen funds, new and existing investors can make new commitments to the fund any time the general partner opens the fund to new commitments. The investment period is tied to an investor's specific capital commitment rather than set from the initial closing of the fund.

With all its advantages, evergreen funds face challenges that stem from the illiquid nature of their assets – the exit of investors (redemptions), the valuation of their interests (for the purposes of subscriptions and redemptions), the structure of the carried interest and the timing of its crystallisation and payment are only a few of the challenges it must tackle and address. While we are still years away from 'market standard' terms for evergreen funds, their popularity with established managers and investors alike is undeniable and both market participants are keen to surmount those challenges.

Another emerging trend in private equity fundraising in light of low interest rates is that Canadian private equity funds are increasingly having recourse to fund-level credit facilities that are becoming more commonly used and are put in place for longer periods and larger amounts. We have seen instances of such credit facilities being used by managers to replace capitals calls at the beginning the fund's life. It will be interesting to see how fund-level credit facilities will affect current market terms.

Lastly, the secondaries market has flourished in recent years in Canada, as it has in the entire North American market and in the European market, with GP-led secondary transactions continuing to grow in popularity in 2020 with Canadian private equity funds.

Chapter 3

CAYMAN ISLANDS

Nicholas Butcher and Iain McMurdo[1]

I GENERAL OVERVIEW

The Cayman Islands (Cayman) are home to a well-established and ever-growing domicile for private equity funds. This can be seen in the statistics issued by the Cayman Islands Registrar of Partnerships. While a Cayman private equity fund can be established as a company, or indeed a trust, the overwhelming majority of Cayman private equity funds are set up as partnerships to mirror the preferred domestic vehicle of choice; in particular, by US managers and sponsors. Specifically, for reasons that are set out later, private equity funds are typically established as exempted limited partnerships (ELPs) in Cayman.[2] At the end of 2020, there was a total of 31,144 ELPs registered in Cayman. This is a 9 per cent increase on 2019 and more than four times the 2006 number of 6,468. The years since the 2008 financial crisis have seen impressive numbers of annual partnership registrations. Following a dip in the number of new registrations, 2020 saw a return to increasing numbers. In 2020, the figure of new partnerships stood at 4,510, compared with 4,328 in 2019, although this is not as high as the peak in 2018 of 5,007 registrations. In 2017, the figure stood at 3,782, in 2016 it was 3,356 and in 2015 it was 3,377.

The reason Cayman has such a well-developed market for private equity funds is a result of its ability to complement onshore fund structures, specifically Delaware partnerships. While founded on Cayman common law principles, which, in turn, are derived from English law, the Cayman Islands Exempted Limited Partnership Act (first enacted in 1991) was drafted to provide symmetry with the corresponding Delaware statute. It has subsequently been amended, but always with a view to dovetailing with the US market. This policy was, and is, simple in design: it was intended, within the confines of Cayman law, to enable a manager's offshore fund to operate and be governed consistently with its domestic offering. Add to this the fact that while English law is technically not binding on a Cayman court, it is persuasive to it; the Cayman legal environment is at once both familiar and robust. Following a detailed consultation, the Law received a comprehensive review and overhaul in 2014 resulting in a new statute, now the Exempted Limited Partnership Act 2018 (the ELP Law). The ELP Law did not make fundamental alterations to the nature, formation or operation of ELPs, but was intended to promote freedom of contract and simplify transactions undertaken by ELPs.

The statute is not, of course, the only reason for Cayman's success. The country provides a tax-neutral environment for fundraising, as under current Cayman law, provided its business is undertaken outside Cayman, no taxes or duties, either directly or by way of withholding,

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2 As the overwhelming majority of Cayman private equity funds are ELPs, in this chapter we describe the law and practice applicable to ELPs, except where it is also helpful to refer to other structures.

will be levied in Cayman on the trading activities or results of a Cayman-domiciled private equity fund. The combination of practical laws and low fiscal costs has secured the country's status as a popular and flexible domicile.

This has led to an interesting characteristic of the Cayman funds market: the vast majority of Cayman private equity funds are established by managers that are not themselves resident in the jurisdiction. The Cayman market facilitates the trading activities of the onshore funds industry, and in this sense the trends we see in Cayman are very much a coefficient of the trends experienced or developed in the United States, Europe, Asia and other major markets. The flexibility of Cayman law allows the manager or sponsor to replicate or accommodate deal terms driven by onshore factors and requirements.

If Cayman does not make the market trends, it certainly mirrors them. The lead-in time for deals appears to be currently increasing and, in some cases, lasts for many months. Increased investor expectation for transparency is reflected in a higher prevalence of side letters along with requests for valid and binding legal opinions – previously it was unusual to issue an enforceability opinion with respect to a side letter; now 20 or 30 opinions might be issued on a single closing.

Successful managers are still able to raise significant funds using Cayman structures. Even allowing for the fact that not every Cayman ELP is formed to serve as the investment vehicle for a private equity fund, transactions in the jurisdiction in 2020 remained robust, spanning a wide range of investment strategies and geographic focus.

II LEGAL FRAMEWORK FOR FUNDRAISING

Prior to 2020, closed-ended private equity funds (i.e., funds in which the capital is locked up for the duration or at least a substantial part of the life of the fund and investors do not have the option to purchase or redeem their interests at their own request) were not required to register with the Cayman financial regulator, the Cayman Islands Monetary Authority (CIMA). This contrasts with open-ended funds, which investors can withdraw at their own option and that have always been required to register with CIMA pursuant to the Mutual Funds Act (2020 Revision). However, in February 2020, Cayman passed the Private Funds Act, 2020 which also requires private (i.e., closed-ended) funds to register with CIMA. Among other requirements, the new law requires prescribed details with respect to the fund to be filed with CIMA and for the fund to have its accounts audited annually by a Cayman-based auditor. Valuation and segregation of asset rules also apply. In late 2020, CIMA also introduced prescribed disclosures for marketing materials for a registered private fund (Content Rules).

Outside of the requirements of this new 2020 Act, the legal basis for the fundraising and ongoing investment activities of a Cayman ELP private equity fund is dictated by the contractual relationship established by, and the disclosures set out in, the offering memorandum, subscription agreement and any other ancillary agreement (most notably side letters), and the ELP Law.

The usual legal form of a Cayman private equity fund is an ELP formed under the ELP Law. While a private equity fund can be, and sometimes is, structured as a company (including, since the introduction of a new law in 2016, a limited liability company (LLC)) or trust, the ELP model has two advantages: it allows US managers in particular to use the same vehicle as they do for their domestic offering while preserving freedom of contract through the limited partnership agreement (LPA), and at the same time avoiding the constraints of the maintenance of capital doctrine that applies to a Cayman company.

Maintenance of capital is the price of limited liability for a company. In general terms, it means that the issued capital of a company cannot be reduced or simply returned to investors. The original intention under English law was to enable a concerned investor to carry out a due diligence exercise, based on the enquiry of the company or inspection of public records, to ascertain the capitalisation of a company. That investor could then form its own view as to whether to invest based on the strength of the covenant implied by the size of the company's share capital. The argument followed that this was an important creditor protection as, given limited liability and separate legal personality, a creditor could, in the usual course of events, only claim against the company, not its shareholders or directors. It therefore followed that the capital needed to be preserved or maintained so that it would be available to satisfy claims. Accordingly, rules, both statutory and common law, grew up to maintain capital, and these are still reflected in modern Cayman company law. For example, a Cayman company cannot reduce its share capital without a court order, special rules apply to the purchase or redemption of its own shares and pure capital (i.e., capital representing the par, or nominal, value of a company's shares) cannot ordinarily be distributed to shareholders.[3]

None of these requirements apply to an ELP, as there is no equivalent of the corporate maintenance of capital doctrine under Cayman partnership law. This is because the general partner (GP) of an ELP has unlimited liability for all the debts and obligations of the partnership to the extent that its assets are inadequate.[4] Conversely, the limited partners (LPs), as the name implies, are not so liable (subject to two important exceptions noted below).[5] This gives investors – the LPs in a Cayman private equity fund formed as an ELP – the best of both worlds: limited liability, but with an almost unfettered ability to receive a return of capital in any situation subject only to the terms of the LPA underpinning the ELP.

An ELP is, in fact, a collection of contractual rights and obligations expressed through the terms of the LPA, which operates under agency principles through the GP and which has a limited liability wrapper for its LPs courtesy of the ELP Law. As the GP both acts for the ELP and has unlimited liability, there are qualifying criteria: at least one GP must be a Cayman company, another Cayman ELP or a natural person resident in Cayman. It can also be an overseas company, including, for these purposes, a Delaware LLC, which registers in Cayman as a foreign company.[6] This is short of a migration of the foreign company to Cayman and there is no reincorporation in Cayman, but a registered office is required along with submission of an annual return and, as discussed below, it can then fall subject to certain Cayman laws. Since the overhaul of the ELP Law in 2014, overseas partnerships can also register in Cayman to qualify as the GP of an ELP. There appears to be no overall preference for choice of qualification, although, in the majority of cases, either a Cayman company or a foreign-registered company will be used.[7]

3 See, for example, Sections 14 to 19 and Section 37 of the Companies Act (2021 Revision).

4 Section 4(2) of the ELP Law.

5 ibid.

6 Section 4(4) of the ELP Law.

7 We should note for completeness that for onshore reasons it is common to see a mezzanine ELP used as the immediate GP to the private equity fund itself, but that mezzanine ELP will itself need a GP, which in turn will typically be one of the corporate models described.

There are no qualifying criteria for LPs; however, an LP is subject to certain statutory restrictions, again being the price for limited liability. Specifically, an LP is passive. In fact, it is prohibited under the ELP Law from taking part in the conduct of the business of the ELP, and the law requires that all contracts, agreements and the like are entered into by the GP on behalf of the ELP.[8]

This leads on to the first of the exceptions to limited liability noted above: in summary, an LP that takes part in the conduct of the business of the ELP can lose limited liability with respect to a third party that deals with that ELP and that reasonably believes the LP to be a GP.[9] However, all is not lost for an LP that wants to exert internal control on the activities of the partnership, as the ELP Law sets out a series of 'safe harbours', which are deemed not to amount to taking part in the conduct of the business. Probably the most helpful of these is as follows:

> *consulting with and advising a general partner or consenting or withholding consent to any action proposed, in the manner contemplated by the partnership agreement, with respect to the business of the exempted limited partnership.*

This is because this is usually sufficient to enable an LP to participate in an advisory committee of the partnership without concern that it could lose limited liability. This is a potential area for tension for an LP that wants to exert control over a GP, and, therefore, by extension, the ELP itself. We advise that the golden rule for an 'active passive' LP is, first, only to participate internally within the partnership, and dealing only with other partners and never with third parties; and second, to have those internal controls expressly documented in the LPA so as far as possible to come within the letter of the safe harbour set out above.

The second exemption to limited liability is clawback on insolvency. If an LP receives a capital – not a profit – distribution and the ELP is insolvent on a cash-flow test at the time the payment is made and the LP has actual knowledge of the insolvency, then that LP can become liable to return the distribution together with interest.[10]

In short, to complete the description of the legal form of an ELP, the partnership does not have separate legal personality: it contracts through the GP, and property vested into the partnership or expressed to be held in its own name is, in fact, held by the GP. Legal actions would be initiated by the GP on behalf of the partnership. Finally, subject to the terms of the LPA, an ELP can have perpetual succession.

In terms of the fundraising itself, Cayman has a disclosure-based legal system; outside of the Content Rules there are no prescribed rules for the content of an offering memorandum for a closed-ended private equity fund. However, whatever is or is not said may potentially be actionable. In addition to a contractual claim under the contracts constituted by the offering memorandum, the subscription agreement and any ancillary agreement (such as a side letter), liability could also arise under principles of negligent or fraudulent misrepresentation, while the Contracts Act (1996 Revision) could apply with respect to pre-contractual

8 Section 14(2) of the ELP Law.
9 Section 20(1) of the ELP Law.
10 Section 34 of the ELP Law.

misrepresentation. To complete the line-up of civil claims, an action for deceit could also arise under tort laws. Finally, in the case of criminal deception, the Penal Code (2019 Revision) could apply.[11]

All this means that the role of adequate disclosure to mitigate the liability of the ELP (along with possibly its GP and promoters), as well as to explain the investment terms, strategy and risk factors, is crucial. If an investor (i.e., an LP in the context of an ELP) can show reliance on a disclosure in the offering memorandum and breach of that disclosure that has resulted in damage, then a claim could ensue. This applies equally to the adequacy of risk factors, for example, as it does to more readily apparent contractual terms such as a statement as to the quantum of fees to be charged by the GP or sponsor.

Specific Cayman disclosures that might be expected, in addition to the investment narrative, terms and risk factors, include the legal form (and especially that the fund, if an ELP, does not have separate legal personality) and the exceptions to limited liability described above. Also typically included would be a statement with respect to tax treatment, transmission of investor information under regulatory laws (see Section III) and a statement that the ELP is only authorised to carry on business outside the Cayman Islands. This latter point is significant to the parameters for the solicitation of investors in Cayman.

While a Cayman company is not allowed, under the Companies Law, to offer its securities for sale to the public unless those securities are listed on the Cayman Islands Stock Exchange,[12] there is no equivalent for an ELP; however, as shall be seen, an ELP is expressly prohibited from transacting business with the public in the Cayman Islands. In fact, this is what 'exempted' in the legal description of an ELP signifies, as only an exempted limited partnership is entitled to apply for the tax-exemption certificate (TEC) described in Section III.[13]

Although there are no equivalents to securities registration statements or investment promotions in Cayman, the legal requirement that the business of an exempted company or partnership must be undertaken outside Cayman means that it cannot generally deal with the public in Cayman (unless, in the case of a company, its securities are first listed on the local exchange). In practice, this means that the investors in a Cayman private equity fund will either be resident overseas or will be other Cayman-exempted entities. One Cayman-exempted vehicle can deal with another, as ultimately their respective businesses are carried out outside, rather than within, Cayman. As the vast majority of Cayman funds are established with exempted status, the restriction does not usually create an issue in practice; however, occasionally a fund will want to take in a Cayman-resident, non-exempt investor. Whether it can lawfully do so will depend on whether the fund has made an offer to the public in Cayman such that it is carrying out business with the public in Cayman.[14]

While specific advice must be sought prior to making an offer in the Cayman Islands, we can extract the following general principles:

a marketing materials can be sent to a limited number of pre-selected investors;

b marketing visits should be made on a one-off basis and should be specific to a limited number of pre-selected investors (unless made on a reverse-enquiry basis);

11 Penal Code (2019 Revision), Sections 247, 248 and 257.

12 Section 175 of the Companies Act (2021 Revision).

13 Section 38 of the ELP Law.

14 Pursuant to Section 183 of the Companies Act (2021 revision), an overseas company selling securities from the Cayman Islands will first need to register as a foreign company under the Companies Law.

c local immigration and licensing requirements may apply;
d the fund can be marketed via a website or other electronic means by the sponsor to the extent that the website is not provided through an internet or electronic service provider (e.g., from a server) in the Cayman Islands;
e unsolicited calls from investors can be responded to, but the making of calls by the sponsor could trigger the public business test;
f outside of the Content Rules, there are no express requirements for the content of marketing materials and, subject to the public offer prohibition, no prescribed minimum or maximum number of offerees; and
g it is advisable that the following jurisdiction-specific statement is included in any offering memorandum or equivalent – 'No offer or invitation to subscribe for [partnership interests] can be made or is made hereby to the public in the Cayman Islands.'

In the vast majority of cases, the sponsor or manager of a Cayman private equity fund will be based onshore, and the fiduciary or other obligations of that sponsor or manager may in part be governed by laws of its own jurisdiction and also the laws of the jurisdiction in which the offer is made; however, the liability, if any, of the sponsor or manager will also be governed by the nature of the contractual arrangements it has with the fund, the scope of its services and obligations, and the extent of any limitation of liability and indemnification. Common carve-outs for exculpation provisions in the context of a Cayman investment fund are fraud, wilful default and gross negligence. Cayman does not have a settled definition of gross negligence, and it is, therefore, usual to see either an express definition or an import of a standard by reference to other laws, usually, in the context of the US market, those of Delaware or New York.

No discussion of fiduciary duties and liability would be complete without referencing the standard for the GP itself. The ELP Law contains a statutory standard that cannot be contracted out of: the GP is required to act at all times in good faith and, subject to the LPA, in the interests of the partnership.[15] There is no statutory standard of fair dealing. While the good faith duty is fixed by statute, the actions of the GP can be subject to contractual limitation of liability and indemnification provisions, although care must be taken to ensure these do not infringe either public policy or common law principles with respect to fiduciary exculpation.

III REGULATORY DEVELOPMENTS

The principal regulatory development of recent times concerning private equity funds in Cayman is the Private Funds Act, 2020, which, in summary, requires closed-ended funds to register with CIMA. Previously, only open-ended funds in which investors can withdraw their interests at their own option were required to register.

An investment manager or sponsor domiciled or registered in Cayman as a foreign company, and carrying out investment management or advice, will be subject to Cayman's Securities Investment Business Act (2020 Revision) (SIBL). This requires that a manager or adviser either be licensed by, or registered with, CIMA. Since 2019, the previous category of 'excluded persons' is no longer available and, accordingly, at a minimum, and, apart from as described below when the GP is a 'non-registrable person', registration is required.

15 Section 19 of the ELP Law.

Registration is possible where the person to whom the services are provided (i.e., the private equity fund itself) is either a sophisticated person within the definitions set out in SIBL or is a high-net-worth person (HNW). As most private equity funds are institutional, the latter test is usually relied upon as this sets the threshold for HNWs at US$5 million in total (as opposed to net) assets.[16] The typical Cayman Islands private equity fund will easily reach this benchmark.

Of course, it is often the case that the GP will provide investment management or advice services to the ELP fund. However, there will be no requirement to register under SIBL, provided it is not separately remunerated for its services other than in its capacity as GP under the LPA and does not otherwise hold itself out as providing such services generally.[17] In these circumstances the GP will be a non-registrable person for the purposes of SIBL.

The private equity fund itself will also be subject to certain reporting requirements: if any person resident in Cayman knows or suspects, or has reasonable grounds for knowing or suspecting, that another person is engaged in criminal conduct or money laundering, or is involved with terrorism or terrorist financing or property, and the information for that knowledge or suspicion came to his or her attention in the course of business in the regulated sector, or other trade, profession, business or employment, the person will be required to report that knowledge or suspicion to the Financial Reporting Authority of the Cayman Islands, pursuant to the Proceeds of Crime Act (2020 Revision) of the Cayman Islands, if the disclosure relates to criminal conduct or money laundering, or a police officer of the rank of constable or higher; or the Financial Reporting Authority, pursuant to the Terrorism Act (2018 Revision) of the Cayman Islands, if the disclosure relates to involvement with terrorism or terrorist financing and property. Such a report shall not be treated as a breach of confidence or of any restriction upon the disclosure of information imposed by any enactment or otherwise.

Invariably a private equity fund will be structured as an exempted vehicle in Cayman, meaning that it cannot do business with the public in Cayman. In the context of an ELP, this means that, in return for a fee of approximately US$1,800, it can apply to the government for, and expect to receive, a TEC. The TEC will confirm that no law subsequently enacted in Cayman imposing any tax to be levied on profits, income, gains or appreciations shall apply to that ELP, or to any of its partners, in respect of the operations or assets of that ELP or the partnership interests of its partners. The TEC will also usually confirm that any such taxes and any tax in the nature of estate duty or inheritance tax shall not be payable in respect of the obligations of the ELP or the interests of its partners.[18]

Currently, the TEC has insurance value only, as under current Cayman law there are no taxes levied in Cayman that would be applicable to an exempted private equity fund. Naturally, investors in the fund will be taxed at applicable local rates when proceeds are repatriated to their own jurisdiction, but there is no first-instance charge to tax in Cayman; however, virtually all funds apply for a TEC.

As will be apparent from the foregoing, there have been no relevant changes in Cayman tax law over the past year, and none are currently expected. Finally, Cayman legislated away the unhelpful decision in the English case of *Mercury*[19] through changes to the Companies

16 Section 2 of SIBL. A different definition applies to an HNW natural person.

17 id., Paragraph 2, Schedule 2A.

18 Section 38 of the ELP Law.

19 *R (on the application of Mercury Tax Group Ltd) v. HM Revenue & Customs* [2008] EWHC 2721.

Law. In summary, the judgment in *Mercury* appeared to require physical rather than electronic closings, which would create obvious impracticalities in the context of modern multi-jurisdictional transactions. The changes to the law effectively allow the contractual parties to determine how agreements will be deemed executed.

The ELP Law was revised in 2014. Principal amendments included:

a enabling the LPA to confirm to whom the GP's good faith duty is owed in given circumstances;
b confirming that, subject to the LPA, LPs do not owe fiduciary duties;
c simplifying the mechanics for admissions of new LPs and transfers of partnership interests; and
d introducing a short-form dissolution procedure.

Cayman has also adopted, in 2014, a Contracts (Rights of Third Parties) Act, which confers on third parties, via an opt-in requirement, a right of enforcement even if they are not a party to an agreement if the actual contracting parties intend to give that right. In the context of an LPA, this means that third-party rights under an indemnity provision, for example, can be enforced by that third party even though it is not a signatory to the LPA.

Revisions to the ELP Law were introduced in early 2013 to authorise the holding of the register of limited partnership interests other than at the registered office, provided that, on request from the Tax Information Authority of the Cayman Islands, details must be made available at the registered office.[20]

The European Alternative Investment Fund Managers Directive (AIFMD) came into force in the European Union (EU) and adhering Member States of the European Economic Area (EEA) from 22 July 2013. Since then, the AIFMD legal and regulatory analysis of Cayman private equity funds has become relatively settled and they have been successfully managed and marketed under the AIFMD regime.

Cayman private equity funds will, subject to limited exceptions, be classified as alternative investment funds (AIFs) under AIFMD.

The identification of each fund's alternative investment fund manager (AIFM) requires a more detailed legal analysis on a case-by-case basis. This includes a review of which entity is performing the majority of the portfolio management or risk management functions, and whether those functions are delegated. In general, this analysis tends to result in the GP or the delegate investment adviser of the GP (e.g., a Cayman GP or a US, EU or Asian delegate adviser) being designated as the AIFM.

Irrespective of the location of the AIFM, different provisions of the AIFMD apply to (1) non-EEA-based AIFMs marketing Cayman Islands private equity funds to investors in the EEA; and (2) EEA-based AIFMs that perform risk management or portfolio management functions for Cayman Islands funds, even if they are not marketing to EEA investors.

At the time of writing, the Cayman Islands complies with the principal requirements for the marketing of non-EEA AIFs into the EEA on a private placement basis. In particular, CIMA has signed the requisite cooperation agreements with the majority of EU Member States, and the Cayman Islands is not listed as a Non-Cooperative Country and Territory by Financial Action Task Force (these requirements also apply to the jurisdiction in which the AIFM is based, if that is outside the Cayman Islands).

20 Section 29 of the ELP Law.

AIFMs must also comply with reporting, disclosure and asset-stripping and EU private equity rules. If the AIFM is based in the EEA, it will need to appoint a depositary to the Cayman Island fund under the 'depo lite' regime. Finally, individual EEA Member States are permitted to impose additional restrictions and accordingly in some EEA markets, local securities laws or marketing rules supplement the foregoing provisions.

In compliance with these provisions, Cayman Islands private equity funds have been successfully marketed into the EEA under the private placement regime since 2014. At the time of writing, the EU Commission has not yet extended the AIFMD marketing 'passport' to any non-EEA jurisdictions. However, the Cayman Islands has been favourably assessed, and in 2019 the Cayman Islands amended certain key financial laws to align with AIFMD requirements and facilitate the marketing of Cayman Islands funds to EEA investors. It also remains to be seen whether the UK will permit wider marketing post-Brexit, now that it is no longer formally bound by EU requirements.

Pending a decision on the marketing passport by the EU Commission, it is also possible for Cayman Islands private equity funds to form part of master-feeder structures, whereby Irish or Luxembourg-domiciled AIFs are used to market to EEA investors pursuant to the AIFMD passport while the Cayman Islands funds are offered to US, Asian or other global investors. The use of parallel fund structures has also become popular, ie. where an EEA version of the Cayman Islands private equity fund is set up for marketing in the EEA.

There are limited exemptions from these marketing rules, including where reverse solicitation rules apply; for dedicated single-investor funds; or where the AIFM manages closed-ended unleveraged assets of less than €500 million.

AIFMs will need to consider carefully the application of AIFMD to such funds before any marketing or management activities are undertaken in the EEA.

Cayman has adopted comprehensive automatic exchange of information regimes and reporting financial institutions have both due diligence and annual reporting obligations in Cayman. Both the Organisation for Economic Co-operation and Development's (OECD) Common Reporting Standard and the US Foreign Account Tax Compliance Act have mandatory application in the jurisdiction. Notifications are made to the Cayman Islands Tax Information Authority administered by the government's Department for International Tax Cooperation.

In 2017, Cayman introduced a new requirement for a beneficial ownership register. Subject to any available exemptions, companies and LLCs are now required to complete and maintain a beneficial ownership register at their Cayman Islands registered office with a licensed corporate service provider.

In the same year, Cayman introduced the Tax Information Authority (International Tax Compliance) (Country-by-Country Reporting) Regulations 2017. In summary, these regulations implement in the jurisdiction the model legislation published under the OECD's Base Erosion and Profit Shifting Action 13 Report (Transfer Pricing Documentation and Country-By-Country Reporting).

Following an overhaul of its anti-money laundering (AML) and terrorist financing regulations (the AML Regulations) in 2017, Cayman continues to revise its AML Regulations to ensure it remains in line with current Financial Action Task Force recommendations and global practice. In summary, the AML Regulations have been expanded in scope to apply to a wider range of Cayman entities; to require the appointment of natural persons as AML officers; and to clarify principles of delegation and reliance in the context of outsourcing the administration of the AML Regulations. In 2020, the AML Regulations were further updated to implement observations made by the Caribbean Financial Action Task Force.

In further response to and compliance with OECD base erosion and profit shifting standards, Cayman has adopted the International Tax Co-Operation (Economic Substance) Act 2020 and associated regulations. This Law brings in reporting and economic substance requirements for certain Cayman entities, with reporting made to the Cayman Islands Tax Information Authority.

An administrative fines regime was introduced in 2020, which gives CIMA the power to levy fines for administrative breaches of rules or laws regulated by CIMA.

IV OUTLOOK

It is fair to say that in the first decade of this century, we witnessed a rise in the formation of successor leveraged buyout funds, with investment periods becoming shorter as sponsors successfully deployed capital in acquisitions. However, in recent years, investment periods have moved back to a more traditional cycle of four to five years. In addition, managers have been seeking to use follow-on investment and recycling provisions to their fullest extent with a view to timing the market on the launch of their next fund. Fundraising conditions (both in terms of fund size and speed to market) remained strong in 2020 and the Cayman Islands continues to be the favoured jurisdiction for fund managers.

The ELP continues to be the favoured vehicle for private equity funds, although 2020 witnessed a decline from the record year of 2018 for the jurisdiction with respect to the number of partnerships formed (4,355 in total, representing a 11 per cent decrease on the peak in 2018). However, this exceeds the numbers formed in any other year, including the banner years of 2007, 2008 and 2017, respectively, and augurs well for the future resurgence of private equity fund formation in the Cayman Islands. There is strong interest from the United States and Europe – traditionally, significant markets for Cayman – but also increasing interest from Latin America and Asia (notably China, Korea and Japan).

The past year was an extremely busy year given that all existing private equity funds caught under the Private Funds Act, 2020 had to register with CIMA and resulted in approximately 12,000 funds being regulated by CIMA in the initial six-month deadline of the new regulatory regime. There has been little change if any in the number of funds being launched under the new regime as investors and managers have accepted that the Cayman Islands is keeping pace with existing international best practices.

It is a characteristic of the Cayman funds industry, since its first inception, that the country has been able to marry robust laws with a pragmatic commercial approach to business. We expect 2021 to be a busy year for the Cayman Islands legislature and that Cayman will continue to refine its laws to ensure it maintains its preferred status among private equity sponsors around the world. As the Cayman Islands continues to respond and adapt to regulatory changes around the world and improve the laws relating to the investment vehicles preferred by sponsors and investors alike, we expect that the next few years will witness a significant growth in the jurisdiction's share of the private equity and venture capital fund formation market.

Chapter 4

CHINA

James Yong Wang[1]

I GENERAL OVERVIEW

The concepts of venture capital (VC) and private equity (PE)[2] were first introduced to China[3] in the late 1980s. Ever since the 1990s, with the rapid growth of China's economy and the unprecedented expansion of start-ups, investments, and mergers and acquisitions, China's PE/VC industry has maintained a strong momentum, and the number of PE/VC firms has grown exponentially.

In the early 1990s, foreign PE/VC firms, such as IDG, entered into the Chinese market and dominated China's PE/VC industry from the late 1990s to 2006. During that period, the majority of foreign PE/VC firms invested via offshore foreign currency-denominated funds in overseas holding companies of enterprises within the territory of China with a 'red-chip' structure.[4] They reaped returns via exit in the United States or other overseas capital markets. However, as a result of growing familiarity with the PE/VC industry within China, the emergence of VC investments in China's technology, media and telecoms (TMT) industries, the development of multi-layered capital markets domestically, and promulgations or

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2 Opinions vary in respect of the relationship between VC and PE. Some argue that VC refers to investments in start-ups or enterprises at their early stages while PE refers to merger and acquisition investments in privately offered equities of non-listed enterprises and listed enterprises. Some argue that PE covers all investments in non-publicly offered equities and thus VC is a branch of PE. However, rules differ in terms of the regulation of PE and VC and the regulatory authorities tend to make a distinction between the two. For instance, the Asset Management Association of China, the self-regulatory organisation of the fund industry in China, divides private funds into securities investment funds, PE funds, VC funds, etc. Thus, in this chapter, unless otherwise mentioned, we distinguish between VC and PE and use PE/VC to describe investments in non-publicly offered equities.

3 For the purposes of this chapter, the People's Republic of China or China does not include Hong Kong, Macao and Taiwan.

4 The red-chip structure adopted by enterprises within the territory of China is a special transactional structure that is established for the purpose of overseas financing and initial public offerings. Usually, shareholders of enterprises within China establish overseas holding companies in offshore jurisdictions such as the Cayman Islands, and make the overseas holding companies acquire, directly or indirectly, equities of enterprises within China held by shareholders. In this way, ownerships of enterprises within China are transferred overseas.

amendments of relevant laws and regulations such as the Law on Partnership Enterprises of the People's Republic of China (PRC), China's domestic PE/VC firms have been developing rapidly since 2006.

Coincident with this development, and in view of the restrictions on foreign investments and foreign exchanges that put foreign currency-denominated funds at a competitive disadvantage, as well as the freeze on shares of Chinese companies listed overseas on account of some fraud scandals, an increasing number of foreign PE/VC firms started to consider and explore schemes for forming yuan funds and exiting via the domestic capital market.

Since 2010, China's domestic PE/VC firms and yuan funds have witnessed dramatic developments, with some media describing it as 'PE fever'. By the end of December 2020, a total of 24,561 private fund managers (PFMs) managing 96,852 private investment funds (PIFs) have been registered with the Asset Management Association of China (AMAC), the self-regulatory organisation of the fund industry in China, with total assets under management of 15.97 trillion yuan.[5]

II LEGAL FRAMEWORK FOR PE/VC MANAGERS AND FUNDS

China's PE/VC legislation remains out of step with the country's burgeoning PE/VC industry and lags behind developments in this sector. VC was not written into China's legal regime until 1996,[6] and for a long time there was no national law regarding the legal status of PE, and no regulation of this area or compliance requirements. Over the past few years, China has adopted a series of significant rules and regulations in relation to the PE/VC industry and a basic legal framework has begun to take shape.

In 2003 and 2005, the Ministry of Foreign Trade and Economic Cooperation (now the Ministry of Commerce) and the National Development and Reform Commission (NDRC) promulgated the Regulations on Administration of Foreign-Invested Venture Capital Enterprises and the Tentative Procedures for the Administration of Venture Capital Investment Enterprises, respectively, which established a legal regime for foreign-invested venture capital enterprise (FIVCE) and domestic venture capital enterprise.

In August 2006, the Standing Committee of the National People's Congress adopted the newly amended Law on Partnership Enterprises and introduced the concept of 'limited partnership', the most popular form of PIFs worldwide. With the growing awareness and acceptance among industrial insiders, limited partnership quickly emerged as the primary form of PE/VC funds in the markets.

In December 2012, the Standing Committee of National People's Congress amended the Law of the People's Republic of China on Securities Investment Funds (the Funds Law), in which 'non-public fundraising' is covered for the first time, and the China Securities Regulatory Commission (CSRC) is authorised to enact relevant rules in practice. The amended Funds Law entered into effect on 1 June 2013 (further amended in 2015). Although the Funds Law specifies that the CSRC oversees 'non-publicly offered' funds, Article 2 of the Funds Law also provides that the Funds Law shall apply to security investment activities

5 See Monthly Report of PFM and PIF Registration (December 2020) released by AMAC, available at www.amac.org.cn/researchstatistics/report/zgsmjjhysjbg/ (last accessed on 18 February 2021).

6 See Law of the People's Republic of China on Promoting the Transformation of Scientific and Technological Achievements (promulgated and entered into effect in May 1996).

by establishing security investment funds through public or non-public fundraising. Thus, controversies arose over whether the provisions of the Funds Law should apply to PE/VC funds that invest in non-publicly offered equities.

In June 2013, the State Commission Office for Public Sector Reform issued the Notice on Allocation of Administrative Authorities over Private Equity Funds that officially bestowed upon CSRC the authority for the supervision and administration of PE funds with the aim of protecting the rights and interests of investors.

As the regulator for the entire private investment fund industry, including PE/VC funds, CSRC authorised AMAC to be responsible for the registration of PFMs and record filing of PIFs, and to perform the self-regulatory function over the entire PIF industry. In August 2014, CSRC promulgated the Interim Measures for the Supervision and Administration of Private Investment Funds (the PIF Interim Measures), which established the system of registration of PFMs and record filing of PIFs, defined qualified investor and clarified non-public fundraising and disclosure requirements for PFMs. Later, AMAC released a series of self-regulatory rules, including but not limited to, the Guidance of Internal Control of Private Investment Fund Managers, the Administrative Measures for Disclosure of Private Investment Funds, the Administrative Measures for Fundraising of Private Investment Funds, the Guidance on Private Investment Fund Contracts, the Administrative Measures for Service Business of Private Investment Funds (for Trial Implementation) and the Guidelines on the Administration of Investor Suitability for Fund Raising Institutions (for Trial Implementation).

Nonetheless, the level of legal authority of the existing supervisory and administrative rules remains relatively low as a whole. Against this background, in August 2017, the Interim Regulations for the Supervision and Administration of Private Investment Funds (Draft for Comments) was released by the Legislative Affairs Office of the State Council, and opinions were solicited from the industry. At the time of writing, the Interim Regulations for the Supervision and Administration of Private Investment Funds have still to be released. However, once released, as administrative regulations from the State Council, these will constitute a significant upgrade to China's private equity industry regulatory regime.

In April 2018, another critical document, the Guidance on Regulating Asset Management Business of Financial Institutions (the Asset Management Guidance), was promulgated by the People's Bank of China together with the China Banking and Insurance Regulatory Commission (CBIRC), CSRC and the State Administration of Foreign Exchange (SAFE). This document aimed to provide a uniform regulatory regime for the asset management industry in China, and a series of ancillary regulatory documents have been promulgated since. Although uncertainty still exists as to its application to the private funds industry, its influence is undoubted.

Most recently, on 30 December 2020,[7] CSRC issued Several Provisions on Strengthening the Regulation of Private Investment Funds (the PIF Provisions), which summarises relative practical experience in the field of PE funds, restates and strengthens the regulatory bottom lines in the field. Among other issues, the PIF Provisions modified the requirement of name and business scope of a PFM for its registration.

7 The Several Provisions on Strengthening the Regulation of Private Investment Funds were released to the public on 8 January 2021.

III GENERAL COMPLIANCE REQUIREMENTS

PIFs in China are required to comply with various operational requirements. Before engaging in any fundraising activity, PFMs established in China (including PFMs with direct or indirect foreign shareholders) must register with AMAC in accordance with the regulations formulated by AMAC. After the completion of fundraising, PFMs have to register the PIFs managed by them with AMAC under the PFMs' names.

i PFM registration

Certain conditions must be satisfied to complete the PFM registration. Since February 2016, AMAC has required any PFM applying for registration to engage Chinese lawyers to conduct due diligence investigations into the PFM, to confirm its compliance in all aspects and to issue a legal opinion. A PFM will not be qualified to be registered unless the legal opinion and other application materials are accepted by AMAC. In November 2017, for the first time, AMAC clearly defined the circumstances under which PFMs will be denied registration in Q&As Related to the Registration and Filing of Private Investment Funds (Q&A No. 14), including illegal fundraising, false statement, engagement in conflicting business, being listed as enterprises with serious illegal and dishonest acts, or discredit of senior executives. In December 2018, AMAC restated the circumstances under which PFMs will be denied registration via a PFM Registration Notice, in which AMAC also listed the main requirements for PFM registration. Basic information of registered PFMs is publicised by AMAC on its official website.

In 2020, AMAC promulgated the Circular on Issues Concerning Facilitating the Application for the Registration of PFMs in February and the Circular on Issuing the List of Application Materials for Record-filing of PIFs in March, listing the materials necessary for the registration of PFMs and record-filing of PIFs, which represents AMAC's effort in enhancing service efficiency, and improving the certainty extent of compliance expectation for related applications.

ii Regulations on fundraising

With the rapid growth and development of the domestic PE/VC industry, irregularities in fundraising have emerged. Therefore, regulatory authorities have issued a series of regulations on fundraising, among which the most important are the Measures for the Administration of the Fundraising of Private Investment Funds (the PIF Fundraising Measures) promulgated by AMAC on 15 April 2016, the Measures for the Administration of the Suitability of Securities and Futures Investors (the Suitability Measures) promulgated by CSRC on 12 December 2016, and the Guidelines for the Implementation of the Appropriateness Management of the Fundraising Institutional Investors (collectively with the Suitability Measures, the New Suitability Management Regulations) promulgated by AMAC on 28 June 2017.

The PIF Fundraising Measures explicitly stipulate that only registered PFMs and entities that have obtained a fund distribution licence from CSRC and a membership of AMAC are permitted to engage in private placement of fund interests. The PIF Fundraising Measures also stipulate specific rules and restrictions in fundraising, such as the guidelines on advertisement and promotion, offline or via the internet. On the basis of the PIF Interim Measures, the PIF Fundraising Measures further require due fundraising procedures and fund industry qualification of personnel engaged in fundraising. On the other hand, the

New Suitability Management Regulations require managers to formulate a uniform standard to classify investors, design a hierarchical risk-control mechanism, regulate the internal management of sales organisations of fund managers and elaborate specific procedures.

iii PIFs registration

Upon completion of fundraising, PFMs must register the PIFs they manage with AMAC, which paves the way for further investment by those PIFs. AMAC places importance on the principle of professional and specialised management for a PFM. When applying for registration, a PFM may only register in one business category (e.g., PE/VC fund manager, private securities investment fund manager) and may only manage PIFs registered as a corresponding type. When registering a fund, AMAC will examine whether the PFM's fundraising activities are in compliance with relevant rules issued by AMAC, including whether the PFM has raised capital from qualified investors for the fund. If an investor is in the form of partnership or other unincorporated form and has not been registered with AMAC, AMAC will 'look through' the investor to the ultimate investors to assess whether the ultimate investors are qualified investors.

The Registration and Filing of Private Investment Funds (2019 PIF Registration Notice) issued by AMAC in December 2019 further embodies the terms under the Asset Management Guidance regarding the operation of PIFs, restating that PIFs' primary business shall not be borrowing or lending activities. According to the Notice, any PIF conducting private lending activities as its regular business, or setting up valuation adjustment mechanisms to engage in disguised loan activities (which separate the PIF's income from the profits or performance of the invested company), will not be permitted for PIF registration.[8] The AMAC also requires that newly registered PFM to complete the record-filing of its first PIF within six months after its registration, or the relevant PFM will be disqualified by AMAC.[9]

iv Information disclosure

AMAC has promulgated several regulations regarding information disclosure by PFMs and PIFs in the past few years, among which the most important are the Regulatory Measures of Information Disclosure for Private Investment Funds and the No. 2 Guideline for Information Disclosure for PE/VC funds. PFMs are required to update both their own registration information with AMAC and the information filed for the PIFs they manage via an online system periodically or each time a material change occurs. In addition, PFMs are also required to disclose to investors information in relation to PIFs they manage according to fund documents (such as the limited partnership agreement).

8 For more information of the 2019 PIF Registration Notice, see the following Jingtian & Gongcheng legal commentary: www.jingtian.com/Content/2019/12-26/1453291876.html (in Chinese).

9 According to Article 13 of Interim Regulations for the Supervision and Administration of Private Investment Funds (Draft for Comments), AMAC will also cancel the registration of any PFM who fails to complete the record-filing procedure within 12 months after the liquidation of all PIFs under its management. If the Interim Regulations comes into effect in the future, AMAC will also cancel the registration of shell or 'zombie' PFMs that fail to maintain the continuous fundraising activities.

v Fund liquidation

PE/VC funds have been booming exponentially since 2009. Because the typical term of a PE/VC fund is 7 to 10 years (with applicable extension), a large number of PE/VC funds will terminate in the near future. It is a significant task for a PFM to arrange an orderly liquidation of a fund. The liquidation of a PE/VC fund shall follow the stipulations under the Law on Partnership Enterprises (or the PRC Company Law for funds organised as companies) and other related regulations, as well as the terms of the fund documents.

IV DOMESTIC INVESTORS

i State-owned enterprises

State-owned enterprises (SOEs) are a major source of capital for PE funds, and in recent years they have also actively sought to act as the general partner (GP), either by itself or in partnership with other parties.

The participation of SOEs as the GP or limited partners (LPs) in a fund creates myriad issues. For example, SOEs are expressly prohibited from acting as the GP under the Law on Partnership Enterprises. It is unclear, however, what constitutes an SOE for the purposes of this prohibition, and different government authorities apply different standards. According to the definition by the State Administration of Industry and Commerce (SAIC), 'SOEs' refers only to wholly state-owned entities, while the NDRC used to consider SOEs to be any type of entity where the direct or indirect aggregate state ownership is no less than 50 per cent. According to Decree No. 32 of the State-Owned Assets Supervision and Administration Commission of the State Council and the Ministry of Finance, released in June 2016, the Decree mainly regulates 'state-owned enterprises, state holding enterprises, and state-controlled enterprises', and generally requires that: (1) the enterprise contains over 50 per cent state capital with the largest investor being an SOE; or (2) the enterprise contains no more than 50 per cent state capital but is controlled by an SOE investor (through agreements or other arrangements) and that SOE investor is the enterprise's largest investor.

Another important issue is the obligation of state-owned shareholders (SOSs) to mandatorily transfer (for free) up to 10 per cent of the issued shares of their portfolio company to the National Council for Social Security Fund (NCSSF) upon the portfolio company's initial public offering (IPO) (the Transfer of State-Owned Shares Regulation). Before the end of 2017, a PE/VC fund with over 50 per cent state ownership may be classified as an SOS of a portfolio company seeking an IPO, and the fund would have to transfer a portion of its shares to the NCSSF for free. In November 2017, with the promulgation of Circular Guo Fa No. 49 [2017] (Circular 49), the aforementioned Transfer of State-Owned Shares Regulation was repealed, which was a significant positive change for PE/VC funds. Circular 49 does not amend other existing regulations related to SOEs. Thus, a PE/VC fund with significant state ownership should consider in advance whether assets held by it will be deemed state-owned assets subject to extra filing, asset evaluation and equity exchange procedures for the disposition of the fund's assets under relevant rules and regulations.[10]

10 These include, but are not limited to, the Law of the People's Republic of China on the State-Owned Assets of Enterprises, the Interim Regulation on the Supervision and Administration of State-owned Assets of Enterprises, the Measures for the Supervision and Administration of the Transactions of State-Owned Assets of Enterprises, the Rules on the Evaluation and Management of State Assets, and the Interim Measures for the Administration of Assessment of State-Owned Assets of Enterprises.

ii Government-guided funds

China's fast-growing PE/VC fundraising activities also benefit from the active involvement of government-guided funds (GGFs) (including, among others, VC investment guidance funds, governmental investment funds and government-sponsored industry investment funds, as defined in related laws, regulations or regulatory policies), which provide a quite considerable amount of capital for PE/VC funds. As most of the GGFs are funded by government-related entities or the government itself with the particular purpose of providing 'guidance', GGFs have several unique features: (1) they are usually incorporated for specific purposes, such as to promote innovation and entrepreneurship, support the growth of small and medium-sized enterprises, enhance industrial transformation and upgrading, and encourage development of infrastructure and public services; (2) they focus on a particular policy guidance feature and normally require a very low proportion of non-state-owned capital; (3) they usually attach particular investment restrictions to their capital commitments; and (4) they usually demand a higher priority in the distribution waterfall to secure the return of their investment costs by surrendering certain upside interest.

iii Insurance companies

Chinese insurance companies have been allowed to invest up to 10 per cent of their total assets in both domestic and offshore PE funds and equity of privately held companies since 2012 (at the end of September 2020, the total assets of the insurance companies amounted to 22.4 trillion yuan).[11] Further, since December 2014, insurance companies have been allowed to invest up to 2 per cent of their total assets as at the end of the final quarter in VC funds. PE and VC sponsors seeking insurance LPs are required to meet two sets of somewhat differing criteria. CBIRC issued the Measures for the Administration of Equity Investments by Insurance Funds (Draft for Comments) in October 2018. Although not promulgated officially, this document shows the tendency towards giving insurance companies more discretion and space with regard to their investments in PE/VC funds.

In addition to being permitted to invest as LPs into PE/VC funds, insurance companies are also permitted to sponsor PE funds as a GP. As at the end of September 2020, 35 insurance PE/VC funds had been registered, with total assets under management of 309.025 billion yuan.[12]

On 13 November 2020, CBIRC promulgated the Circular of Matters Related to Financial Equity Investment of Insurance Funds to improve the regulatory policies on equity investment with insurance funds by removing the industrial restrictions on financial equity investment with insurance funds and refining the mechanism of 'negative list + positive guidance', releasing to a certain extent the industrial restrictions on direct equity investment with insurance funds and refining the risk management of portfolio companies.[13]

11 For more information, available at www.gov.cn/shuju/2020-11/13/content_5561279.htm.

12 For more information, available at www.iamac.org.cn/cpzc/zcsj/202011/t20201105_6835.html.

13 For more information, see the following Jingtian & Gongcheng legal commentary: www.jingtian.com/Content/2020/11-17/1737231057.html (in Chinese).

iv Banks and the NCSSF

The tremendous wealth management funds of commercial banks have always been very attractive to PE/VC institutions. However, as the investment of such banking funds is strictly restricted, the path for PE/VC institutions to raise banking funds is not smooth. Pursuant to pertinent regulations, only wealth management funds of qualified private banks/high-net-worth clients can participate in equity investments. Therefore, for a considerable time, wealth management funds, other than those of qualified private banks/high-net-worth clients, were usually invested in PE/VC funds through trust plans or asset management plans sponsored by other non-bank financial institutions, taking advantage of the vacuum caused by separate regulation of financial institutions. The Asset Management Guidance intends to strengthen the regulation of banks' asset management business and eliminate this regulatory vacuum by requiring commercial banks to establish independent wealth management subsidiaries to detach wealth management business from other banking business. At the same time, the Asset Management Guidance also indirectly opens another door for banks to carry out broader asset management business. Since the ancillary regulations of the Measures for the Supervision and Administration of the Wealth Management Business of Commercial Banks and the Administrative Measures for Wealth Management Subsidiaries of Commercial Banks came into force successively, certain wealth management products of commercial banks have been able to invest in equity assets, including stocks listed and traded domestically, the equity of unlisted enterprises and the beneficiary rights (rights to returns) thereof. Further, a wealth management subsidiary of a bank may also select qualified PFMs to act as its cooperation organisations and invest certain qualified wealth management products in PIFs sponsored and managed by such PFMs, which is undoubtedly a piece of significantly positive news for the PE/VC industry.

For first-tier PE/VC sponsors in China, another deep-pocketed LP to go after is the NCSSF. Since May 2008, the NCSSF has been permitted to allocate up to 10 per cent of its assets to domestic PE funds (investments in offshore PE funds are not yet permitted). By the end of 2019, the total assets of the NCSSF were 2,628.566 billion yuan, including 1,041.017 billion yuan of direct investment assets, accounting for 39.60 per cent of the total assets of the NCSSF; 1,587.549 billion yuan of entrusted investment, accounting for 60.40 per cent of the total assets of the NCSSF; 2,366.869 billion yuan of domestic investment, accounting for 90.04 per cent of the total assets of the NCSSF; and 261.697 billion yuan of overseas investment, accounting for 9.96 per cent of the total assets of the NCSSF.[14]

V FOREIGN INVESTORS

The form of fund with foreign participation (either as a GP or investors or both) has evolved over the years.

i Foreign-invested venture capital enterprise

Before the advent of the limited liability partnership (LLP) in China, foreign fund sponsors primarily formed onshore funds in China in the form of an FIVCE under the Administrative Regulation for Foreign-Invested Venture Capital Enterprises (the FIVCE Regulation)

14 Please see the Annual Report on National Council for Social Security Fund (2019) available at www.ssf.gov.cn/cwsj/ndbg/202009/t20200910_7798.html.

promulgated on 30 January 2003. An FIVCE may be set up either as a 'non-legal-person Sino-foreign cooperative joint venture' (non-legal-person FIVCE) or as a limited liability company (LLC or corporate FIVCE). A corporate FIVCE is typically used by one or more foreign fund sponsors to set up an onshore fund exclusively with foreign currency capital, whereas a non-legal-person FIVCE was the popular form for a foreign fund sponsor to pool onshore and offshore capital together, often in partnership with a Chinese fund sponsor.

An FIVCE (whether in non-legal-person or corporate form) is required to have a 'requisite investor' that plays a role similar to a GP to a partnership fund. The requisite investor is required to satisfy certain requirements, including, but not limited to having VC investment as its main line of business; having cumulative capital under management of at least US$100 million (or 100 million yuan in the case of a Chinese investor acting as the requisite investor) in the previous three years; and subscribing for and contributing at least 1 per cent (in the case of a non-legal-person FIVCE) or 30 per cent (in the case of a corporate FIVCE) of the total size of the FIVCE.

An FIVCE is required to have a minimum fund size of US$5 million or the yuan equivalent (in the case of a corporate FIVCE) and US$10 million or the yuan equivalent (in the case of a non-legal-person FIVCE). Each investor other than the requisite investor is required to invest at least US$1 million or the yuan equivalent.

The non-legal-person FIVCE was very popular before the advent of the LLP because it was the legal form closest to an LLP. The FIVCE Regulation allows the investors of a non-legal-person FIVCE to agree that the requisite investor assume joint liability to the FIVCE and the other investors to assume limited liability up to their capital commitments (in contrast, all investors of a corporate FIVCE enjoy limited liability protection). A non-legal-person FIVCE was also allowed to be treated as a tax pass-through entity, similar to a partnership, in which case the income of the FIVCE would not be taxed at the fund level but would be allocated and directly taxed in the hands of its investors. The tax pass-through treatment, however, was not well understood by many local tax authorities, causing many non-legal-person FIVCEs to be unable to enjoy the tax pass-through status in many local jurisdictions. As the LLP form was made available to foreign-invested PE funds in 2010, and the provision granting tax pass-through status to non-legal-person FIVCEs was officially repealed in 2011, the FIVCE became a much less desirable legal form for foreign-invested funds in China.

ii Qualified foreign limited partner and renminbi-qualified foreign limited partner

As discussed in Section II, the Law on Partnership Enterprises was amended in 2006 to permit the LLP form, which spurred the growth of domestic LLPs (DLPs). As foreign investment and foreign exchange is tightly regulated in China, however, foreign fund sponsors and investors had not been able to avail themselves of the new LLP structure until the SAIC promulgated the Administrative Regulations on the Registration of Foreign-invested Partnership Enterprises in 2010 and Shanghai released trial regulations on its qualified foreign limited partner (QFLP) pilot programme in January 2011.[15] The pilot programme

15 Beijing, Tianjin, Chongqing, Shenzhen, Qingdao, Guiyang Free Trade Zone, Pingtan, Zhuhai, Guangzhou, Suzhou, Xiamen, Hainan, Liaoning Pilot Free Trade Zone (Shenyang Area) followed suit in adopting their own versions of the QFLP pilot programme, which were all modelled on the Shanghai version. Of all the cities with a QFLP pilot programme, the Shanghai programme is by far the most successful while the Tianjin programme is more time-efficient. Shenzhen released Circular Shen Jin Gui [2017] No. 1 (New Shenzhen QFLP Rule) in September 2017, which improved the QFLP pilot programme it had

opens the door for foreign sponsors to set up onshore funds in China in the form of LLPs and brings clear advantages over the traditional FIVCE or offshore fund model. In particular, in contrast to an FIVCE, which is now subject to a 25 per cent Enterprise Income Tax (EIT), a QFLP fund as a partnership enjoys tax pass-through treatment at the fund level. In addition, an offshore fund has to go through the time-consuming approval process with SAFE for each of its investments into China, and the portfolio company, which would receive foreign currency capital from the fund, must seek SAFE approval for foreign exchange settlement on each occasion that it needs to use such capital. In contrast, SAFE approval for a QFLP fund is done at the front end (namely, at the time of the fund formation), and foreign currency capital may be converted into yuan directly with the custodian bank in a prompt manner (typically close to one week), thus avoiding the lengthy SAFE approval process for each investment and also saving the portfolio company the trouble of having to seek SAFE approval for foreign exchange settlement. With the promulgation, by SAFE, of Circular Hui Fa [2015] No. 19 (Circular 19) in March 2015, Circular Hui Fa [2016] No. 16 (Circular 16) in June 2016 and Circular Hui Fa [2019] No. 28 (Circular 28) in October 2019, the previous stringent payment-based foreign exchange settlement system for foreign-invested enterprises (FIEs) has been replaced by a foreign exchange settlement system for FIEs where FIEs are allowed to settle foreign exchange-registered capital at their discretion and then make equity investments with renminbi (yuan). Circulars 19, 16 and 28 are intended to put the rest of the country on the same level playing field as the QFLP pilot areas. However, in practice, the QFLP pilot areas are still considerably ahead of the rest of the country in terms of the implementation of these foreign exchange regulations and thus remain the preferred location for foreign PE/VC firms contemplating QFLP fund formation at this time.

For those fund sponsors that have not previously managed onshore funds, a QFLP fund could also bring certain reputational and other intangible benefits. To date, dozens of foreign sponsors have received QFLP licences for their PE funds in Shanghai, including leading PE firms such as Blackstone, Carlyle, TPG, 3i Group, Hony Capital and SAIF.

Over the past few years, three main models have emerged for QFLP funds: (1) the DLP model, where the foreign fund sponsor sets up a wholly foreign-owned enterprise (WFOE) to act as the GP or management company of a DLP and raises capital solely from domestic investors in yuan (as exemplified by the Blackstone QFLP fund); (2) the co-GP–joint venture foreign limited partnership (FLP) model, where the foreign fund sponsor partners up with a Chinese fund sponsor to set up a joint-venture management company and raises capital from both domestic and offshore investors (as exemplified by the Carlyle–Fosun QFLP fund); and (3) the wholly foreign-owned FLP model (as exemplified by the Fidelity QFLP fund). QFLP funds and their management companies are required to include 'equity investment' and 'equity investment management' in their company names and business scope. Additionally, both the New Shenzhen QFLP Rule, released in September 2017, and the Zhuhai QFLP

formed in 2012. On 26 October 2020, Shenzhen Local Financial Supervision Administration issued the Announcement on Seeking Public Comments on the Measures of Shenzhen Municipality for the Pilot Program of Foreign-invested Equity Investment Enterprises (Draft for Comments), which further increases the flexibility of the pilot programme of Shenzhen QFLP pilot programme comparing to New Shenzhen QFLP Rule. On 10 October 2020, Hainan QFLP Rules were promulgated, making new breakthroughs comparing with other QFLP pilot programmes,including but not limited to: (i) no minimum access threshold for the establishment and registration of relevant entities in Hainan; (ii) non-discriminatory treatment for both domestic and foreign investors; and (iii) no restriction upon the scope of investment for Hainan QFLP funds except the industries set forth in the negative list.

measures, released in January 2019, explicitly permit a 'domestic manager managing foreign capital' model (the New Model), by which a pure domestic fund management institution, subject to certain requirements, may raise funds from offshore investors to establish a foreign-invested equity investment enterprise.

The nature of a QFLP fund as a domestic or foreign fund is also an important issue. Under Chinese laws, it is very clear that QFLP funds under the above-mentioned models (2) and (3) and the New Model are deemed to be foreign investors in terms of their investments and are required to go through the same foreign investment process as an offshore fund (except for the differences in the foreign exchange approval and conversion process as described earlier). However, the nature of a QFLP fund under model (1) above is less than clear. According to a written reply from the NDRC to its local counterpart in Shanghai on the classification of the Blackstone QFLP fund in April 2012, it was made clear that the investments by such funds still have to comply with the Catalogue for the Guidance of Foreign Investment Industries (the Foreign Investment Catalogue) (e.g., with respect to the prohibition against and restrictions on certain industries, such as the TMT industry and the culture and entertainment industry), even where the fund is issued a business licence as a DLP rather than as an FLP and the portfolio company is not required to be converted to an FIE. Furthermore, the New Shenzhen QFLP Rule explicitly provides that foreign-funded equity investment enterprises are required to directly invest in portfolio companies in compliance with the Foreign Investment Catalogue. Since the Foreign Investment Law came into force on 1 January 2020, the foreign investment management regime based on the examination and approval system has been completely removed and replaced by the *ex post* reporting regime for foreign investment, greatly simplifying the foreign investment procedure.

It is very common for foreign sponsors to seek to raise yuan capital exclusively from Chinese investors, namely, under model (1) above. To avoid the time-consuming process of applying for a QFLP licence and foreign investment restrictions, foreign sponsors often choose to set up a pure DLP free from any foreign investment restrictions. To our knowledge, one approach used by certain market participants to structure a pure DLP is to use Chinese nationals (e.g., Chinese members of the team or family members of the relevant principals) to set up a purely domestic LLC and to put a series of contractual arrangements in place between the GP and the WFOE management company. Careful advance legal and tax planning is required to ensure that such contractual arrangements provide effective control over the GP and are enforceable under Chinese laws, and that the economics of the fund (e.g., carried interest and management fee) are structured in a way consistent with the commercial intentions of the fund sponsor.

Another variation of the QFLP fund is the renminbi-qualified foreign limited partner (R-QFLP) fund, where offshore yuan as opposed to foreign currency capital is used to set up the fund. The R-QFLP pilot programme has been less successful, partly because it is subject to additional regulation by the People's Bank of China with respect to the use of offshore yuan by the fund.

VI STRUCTURING OF OUTBOUND INVESTMENT FUNDS

i Outbound direct investment

In 2016, China witnessed huge growth (an increase of 44 per cent) in outbound direct investment (ODI), even though the Chinese government has significantly tightened the ODI and other outbound investment filing and approval channels on account of significant concerns about capital flee and foreign exchange imbalance. The year 2017 witnessed a significant drop in ODI activities as the government was determined to crack down on the illegal transfer of domestic assets offshore through such activities. Since late 2017, however, with the gradual improvement of the foreign exchange imbalance, the government appears to have been cautiously reopening the door for ODI activities, but at the same time it has also significantly raised the disclosure requirements for ODI approval and record filing by means of a series of new rules from the NDRC in late 2017 and early 2018. These rules include Order No. 11, promulgated by the NDRC on 26 December 2017 and effective since 1 March 2018, which strengthened the supervision of channels for outbound investments by detailing the sensitive industries to be regulated and clarifying the requirements regarding ODI application materials. The competent departments involved in the ODI process are mainly the NDRC, the Provincial Development and Reform Commission (PDRC), the Commerce Department, the Provincial Bureau of Commerce and SAFE. Generally, ODI in sensitive projects[16] must be approved by the NDRC, and for ODI in non-sensitive projects, records must be filed with the NDRC or PDRC or disclosed to the NDRC identifying investors and detailing the method of investment and the investment amount. In addition, in a regulatory first, Order No. 11 places ODI activities by PRC individuals through overseas enterprises under the PRC individuals' own control and those by enterprises in Hong Kong, Macao and Taiwan within the scope of supervision, which means such ODI activities shall be subject to the approval and record-filing requirements mentioned above.

ii Qualified domestic limited partnership

The qualified domestic limited partnership (QDLP) pilot programme, which originated in Shanghai and was further developed in Beijing, Chongqing, Tianjin and Qingdao, allows qualified foreign-invested overseas investment fund management enterprises to raise capital from qualified domestic investors to set up overseas investment funds for outbound investments. Approval for the QDLP pilot programme was materially suspended from September 2015 until the end of 2017 following changes in regulatory policies on cross-border flows of foreign exchange. On 24 April 2018, SAFE officially announced the expansion of quotas for the QDLP pilot programme in Shanghai to US$5 billion, and on 8 December 2020, SAFE further approved an increase in Shanghai's QDLP quotas to US$10 billion. Since the resumption of approval of the QDLP pilot programme at the end of 2017, a number of institutions have successively obtained QDLP quotas. In addition, as

16 According to Order No. 11, Article 13, sensitive projects shall include: (1) projects involving sensitive countries and regions; and (2) projects involving sensitive industries. For the purpose of these Measures, sensitive countries and regions shall include: (1) countries and regions that have not established diplomatic relations with China; (2) countries and regions where war or civil unrest has broken out; (3) countries and regions in which investment by enterprises shall be restricted pursuant to the international treaties, agreements, etc., concluded or acceded to by China; and (4) other sensitive countries and regions. For the purpose of these Measures, sensitive industries shall include: (1) research, production and maintenance of weaponry and equipment; (2) development and utilisation of cross-border water resources; (3) news media; and (4) other industries in which outbound investment by enterprises has to be restricted pursuant to China's laws and regulations and related control policies. According to the Notice of the National Development and Reform Commission on Promulgating the List of Sensitive Industries for Outbound Investment (2018 Edition), sensitive industries shall include: (1) real estate; (2) hotels; (3) cinemas and theatres; (4) the entertainment industry; (5) sports clubs; and (6) the setting up of equity investment funds or investment platforms with no specific industrial project overseas.

the latest QDLP pilot city, Beijing was approved by SAFE to increase the QDLP quotas to US$10 billion as well. The QDLP pilot programme in Beijing launched in January 2020 has attracted much attention since then. By the end of 2020, two well-known international asset management institutions (Oaktree Capital and Amundi Group) successfully achieved QDLP licences and quotas in Beijing.

iii Qualified domestic investment enterprise

The qualified domestic investment enterprise (QDIE) pilot programme, which was promulgated in Shenzhen, allows qualified overseas investment fund management enterprises to raise capital from qualified domestic investors to set up overseas investment funds for outbound investments. By the end of 2015, QDIE quotas had been granted to more than 40 enterprises since the implementation of the QDIE pilot programme in 2014, with quotas increasing from the initial US$1 billion to US$2.5 billion.

However, approval for the QDIE pilot programme was gradually withdrawn and then materially suspended in 2016. The QDIE pilot programme subsequently appeared to resume at the beginning of 2018. On 24 April 2018, SAFE officially announced the expansion of quotas to US$5 billion for the programme in Shenzhen, matching the quotas for the QDLP pilot programme in Shanghai. In December 2020, SAFE further approved the expansion of QDIE quotas to US$10 billion. According to the statistical data disclosed in Instructions on Revising the Administrative Measures for Carrying Out the Pilot Program of Outbound Investment by Qualified Domestic Investors (Draft for Comment) by Shenzhen Local Financial Supervision Administration, by the end of 2019, a total of 48 entities, including several licensed asset management institutions, subsidiaries of fund managers, securities companies, fund companies and other types of entities, have been qualified for the QDIE pilot programme, with total quotas of US$1.551 billion.

VII TAXATION

Tax is critical to the fund structuring process in China. As tax rules with respect to PE/VC funds and their partners are less settled, the room for tax planning and the downside for lack of or inappropriate tax planning may be significant.

As in the United States, Hong Kong and a number of other jurisdictions, the tax status of carried interest received by the GP remains less than clear. In the United States, for example, legislative proposals have been raised from time to time to try to redefine carried interest from capital gain to ordinary income since 2006. The risk of carried interest being taxed as service income appeared fairly remote in China until early 2017, when a major New Third Board-listed private equity firm was penalised by a local tax authority for having failed to pay value added tax (VAT) on carried interest. Prudent advance tax structuring during the fund formation process thus became extremely important in this respect.

Under Chinese tax law, dividend income between two LLCs is exempt from EIT to avoid double corporate taxation (inter-LLC dividend exemption). For the same reason, dividend income from a corporate PE/VC fund to an investor that is an LLC (a corporate investor) is also exempt from EIT. Because a fund typically receives most of its income from the disposition of portfolio interests, which is then allocated and distributed to its partners, for a corporate investor it makes no significant difference whether the fund is an LLC or an LLP as far as EIT is concerned, because only one layer of EIT will be incurred, either at the corporate PE/VC fund level or at the corporate investor level.

On the other hand, the form of the fund greatly concerns individual investors. An LLC fund is generally subject to EIT and an individual investor in the fund is generally subject to individual income tax (IIT) at a rate of 20 per cent with respect to investment returns from the fund (i.e., two layers of taxes will be incurred). For an LLP fund, no EIT occurs at the fund level because an LLP is treated as a tax look-through entity in China. However, for a long time now it has been less clear in practice whether investment returns from private funds received by an individual investor are subject to the 20 per cent rate or a progressive rate of IIT ranging from 5 to 35 per cent. The promulgation of Circular Cai Shui [2019] No. 8 (Circular 8) in January 2019 makes it clear for the first time how IIT will be calculated for individual investors in venture capital investment enterprises (VCIEs) in the form of an LLP. Circular 8 stipulates that a VCIE may choose to apply either 'single portfolio accounting', by applying a fixed rate of 20 per cent IIT, or 'annual income overall accounting', by applying a rate ranging from 5 to 35 per cent IIT. Because a fund in LLC form would be subject to an additional layer of tax (EIT) on its income from the sale of portfolio interests, LLP funds are clearly more tax-efficient for individual investors that directly or, through income-tax-transparent vehicles (such as a fund of funds in LLP form), indirectly invest in the funds. With the nationwide advancement of VAT reform in China since 2016, the financial industry has been included in the scope of this reform. Subject to different types of investment targets, VAT may be imposed on PE/VC funds on the basis of VAT taxable income (e.g., the bond interest income, and income derived from trading in financial instruments, such as stocks and bonds). Considering that contractual funds have no legal personality and do not require any tax registration, there were uncertainties as to how the VAT scheme would apply to contractual funds in practice. In 2017, a series of guidance regulations were issued by the Ministry of Finance and the State Administration of Taxation (SAT), which clarified that asset managers are VAT taxpayers for the VAT imposed on asset management products, and a simplified VAT calculation method will apply to the VAT taxable income of those asset management products (including contractual funds) at a rate of 3 per cent, effectively as of 1 January 2018. However, for PE/VC funds in the LLP or LLC form that were subject to clear VAT rules (i.e., 6 per cent) prior to the issuance of these documents, there is still uncertainty as to whether the simplified VAT calculation method at the rate of 3 per cent for asset management products applies.

The taxation of an FLP, or more specifically, its offshore partners, remains unclear. One school of thought among the Chinese tax community was that the withholding tax (WHT) at a rate of 10 per cent applicable to foreign invested enterprises in the form of LLC should apply to dividend income from the FLP to an offshore partner, including carried interest to the offshore GP; the WHT could be reduced to 5 per cent if the offshore partner could avail itself of the reduced WHT pursuant to a tax treaty between China and the jurisdiction of formation of the foreign partner (unless the offshore partner was deemed to have a permanent establishment in China, in which case it would be subject to the 25 per cent EIT). This school of thought, however, has not been accepted by Chinese tax authorities, and efforts of tax advisers to negotiate and convince local tax bureaus to accept a 10 per cent WHT have had little success to date. In practice, given the lack of clear guidance on the taxation of offshore partners of an FLP (such as a QFLP fund), some local tax bureaus have been requiring a 25 per cent WHT on dividend income before it may be repatriated to its offshore partners (without distinguishing between the GP and LPs).

VCIEs that are duly registered with the NDRC or AMAC and angel investment individuals enjoy special preferential tax treatment in several pilot areas[17] pursuant to Circular Cai Shui [2017] No. 38 (Circular 38),[18] with effect from 1 January 2017. If they hold investments in qualified seed or early-stage technology enterprises for a period of at least two years, they are permitted to apply 70 per cent of their total investment amount in the qualified enterprises to offset their taxable income, with any excess carried forward to subsequent years. In the case of VCIEs formed as LLPs, the 70 per cent tax benefits could be passed along to their corporate or individual LPs. Circular Cai Shui [2018] No. 55, effective since 1 July 2018 and superseding Circular 38 enabled the rest of the country to enjoy the same VCIE tax treatment policies as the several pilot areas listed in Circular 38.

Based on China's commitment to the mutual exchange with other jurisdictions of financial account information of foreign tax residents,[19] the Administrative Measures on Due Diligence Checks on Tax-Related Information of Non-residents' Financial Accounts (Announcement 14) was promulgated on 9 May 2017, marking the localisation of the Common Reporting Standard in China. Pursuant to Announcement 14, as from 2018, financial institutions, including PFMs and PIFs, shall identify the tax-resident identity of the holder or relevant controlling person of any account, identify non-resident financial accounts,[20] and report account-related information to the SAT.

VIII OUTLOOK

As a concept learned from the Western world, the PE/VC market in China has grown at a phenomenal rate over the past 20 years and has helped create many of the leading Chinese companies and global technology giants, such as Tencent and Baidu. At the same time, this phenomenal rate of growth has also caused myriad business and legal issues, some of which are unique to China. As more and more Chinese laws and regulations have been promulgated, the whole regulatory system has continued to lag seriously behind the development of the industry in many respects and has remained characteristically vague in relation to many other aspects of this sector. Regulators are working hard to play catch-up while protecting their own turf. It is a most dynamic market – one in which the law changes much faster than it does in other developed countries, and in which great opportunities and great challenges coexist.

17 The pilot areas include Beijing, Tianjin, Hebei, Shanghai, Guangdong, Anhui, Sichuan, Wuhan, Xi'an, Shenyang and Suzhou Industrial Park.

18 Circular 38 has since been abolished by Circular Cai Shui [2018] No. 55.

19 These commitments were made by China when signing the Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information in tax matters with the Organisation for Economic Co-operation and Development in December 2015.

20 'Non-resident financial accounts' refers to the financial accounts opened or maintained by China's domestic financial institutions and held by non-residents or passive non-financial entities with non-resident controllers.

Chapter 5

GERMANY

Felix von der Planitz, Natalie Bär and Maxi Wilkowski[1]

I GENERAL OVERVIEW

In 2017, private equity fundraising remained at almost the previous year's level at €2.98 billion, as reported by the German Venture Capital Association (GVCA) in its annual yearbook. About half of this total referred to venture capital funds. Venture capital fundraising increased slightly from €1.33 billion to €1.49 billion. On the other hand, the fundraising of buyout funds with €0.94 billion was around 35 per cent lower than its value by the end of the past year. Investments into Germany-based portfolio companies increased to €11.31 billion, which is about 67 per cent more than in the previous year. Seventy-nine per cent of these investments were made into buyouts. Venture capital investments (seed, start-up, later-stage venture capital) remained broadly unchanged and amounted to €1.05 billion.

The German tax and regulatory environment has become even more challenging for private equity funds (namely on account of BEPS,[2] FATCA/CRS, the Investment Tax Reform Act, VAT on management fees, tax transparency and permanent establishment issues, rumours regarding future restrictions of the German capital gains tax-exemption regime, and carried-interest taxation issues).

Private equity funds and other alternative investment funds (AIF) are regulated in Germany pursuant to the German Capital Investment Code (KAGB) that implemented the Alternative Investment Fund Managers Directive 2011/61/EU (AIFMD) into German law. In Germany, not only the national investment regulation has been revised to transpose the AIFMD, but the existing product regulation of the abolished previous German Investment Act has been extended to include closed-ended funds and alternative assets in the KAGB.

The KAGB and its interpretation by the German Federal Financial Supervisory Authority (BaFin) are often more restrictive than the national legislation implementing the AIFMD in other countries of the European Union. Therefore, an increasing number of German fund managers have begun to establish more teams with an international focus and offer non-German fund structures, either onshore (i.e., Luxembourg, the Netherlands, Ireland) or offshore (i.e., Guernsey, Jersey) to German investors. Compared to countries such as the United Kingdom, France and Italy, German private equity funds do not achieve billion-euro commitments. Billion-euro allocations for German investments are more likely to be integrated into pan-European private equity funds with strong German advisory teams.

1 Felix von der Planitz is a partner and Natalie Bär and Maxi Wilkowski are senior managers at PwC. The information in this chapter was accurate as at March 2018.

2 The OECD (2013) Action Plan on Base Erosion and Profit Shifting (BEPS) was published in July 2013 and identifies 15 actions to address BEPS in a comprehensive manner, and sets deadlines to implement these actions.

In terms of asset classes, the trend of the preference of German institutional investors continues to shift from classic buyout to debt funds, infrastructure funds, renewable energy funds and other real asset funds (i.e., timberland) that aim to generate an ongoing yield. Based on a survey conducted by the GVCA, institutional investors in Germany are highly satisfied with their involvement in private equity and have recently expanded their investments in the private equity sector, and are planning to increase their commitments in the future.[3]

In terms of investors, most of the newly raised capital has been provided by individual investors and family offices as well as institutional investors (in particular German insurance companies, pension funds and pension schemes). Institutional investors are often entitled to a beneficial taxation of capital gains (95 per cent exemption for many corporate investors, tax exemption for pension funds, flat tax rate of 25 or 40 per cent exemption for individual investors). However, the former 95 per cent dividend exemption was abolished for dividends that German or non-German corporations would receive from minority shareholdings (less than 10 per cent). On the subject of the flat tax regime, whether it should be abolished in the future is currently being discussed at the political level.

II LEGAL FRAMEWORK FOR FUNDRAISING

In Germany private equity funds are generally regulated according to the KAGB, which entered into force in 2013 and has transposed the European AIFMD into German law. The KAGB is applicable to AIF domiciled or distributed in Germany and – with respect to the implementation of the AIFMD – also provides for a regulation of Germany-based fund managers or those that provide their services via using the European passport (freedom to provide services in another Member State).

In this section, no distinction is made between AIFs that are internally managed and AIFs that are externally managed. In practice, however, an internally managed fund, namely a fund that does not appoint an external manager but rather manages itself and obtains authorisation as an alternative investment fund manager (AIFM), is generally the exception as regards German AIFs. However, one has to consider that an external AIFM must have a certain legal form as stock company (AG), limited liability company (GmbH) or limited partnership, where the general partner is a limited company (GmbH & Co KG).

i German limited partnership

The most common German fund structure for private equity funds is a German limited partnership (KG) (referred to as an 'investment KG' in the KAGB). In this respect, German law principally follows the Anglo-American limited partnership-type fund structures.

The general partner can be a German limited company (GmbH) or even another German limited partnership (e.g., a GmbH & Co KG). Given the illiquid nature of private equity-related investments, it is in principle not possible to set up a private equity fund as open-ended. Shares in a closed-ended investment KG may according to the KAGB only be held by (semi-)professional investors directly. A trustee arrangement may only be used in the case of a closed-ended retail investment KG, whereby the agreement must limit the activity of the fund to the investment of raised capital and management of the held assets (no operative

3 Private Equity as Asset Class for Institutional Investors and Family Offices: Result of a Survey among Institutional Investors in Germany, published by the German Private Equity and Venture Capital Association in July 2017.

or commercial activities). The fund must have a defined investment policy additionally to the limited partnership agreement. In principle, an investment KG partnership agreement will appear to be quite similar to an Anglo-American limited partnership agreement, although the KAGB requires certain specifications. Both the limited partnership agreement and the investment policy, as well as any marketing documents, have to be notified to and, in the case of retail funds, be approved by BaFin.

For legal purposes, the German limited partnership is quite competitive with those of other jurisdictions.

However, German partnership law provides for some tax-driven adjustments. The main legal differences of a German limited partnership agreement compared with a limited partnership agreement under English law are as follows:

a no loan commitment – as opposed to an English limited partnership, a German limited partnership agreement would not have to provide for a loan commitment. Instead, the commitments of the limited partners to the capital of a German limited partnership would be divided into a small capital contribution and a large preferred capital contribution;

b managing limited partner – in addition to the general partner, a limited partner (GmbH, an individual or another German limited partnership) would be entitled to certain management responsibilities. The managing limited partner concept is mainly tax-driven and aims to achieve the qualification of an asset management partnership (non-trading) rather than a trading partnership, and in particular to avoid a permanent establishment and thereby tax filing obligations in Germany; and

c priority profit share – the German limited partnership would provide for a priority profit share to be paid to the general partner or the managing limited partner, or both, rather than a management or performance fee. This is again tax-driven to achieve certain VAT advantages, if possible. In practice, it is difficult to obtain a VAT exemption; therefore, Germany is not competitive compared with a Luxembourg partnership structure or – for instance – funds on the Channel Islands. However, if a fund qualifying as an AIF is externally managed, it can be assumed that a significant share of income paid to the fund manager must be classified as a management fee, given the activities that must be performed by the AIFM from a regulatory perspective.

ii German partnership limited by shares

Another local fund structure is the German partnership limited by shares (KGaA), which is comparable with a Luxembourg partnership limited by shares (SCA) because in both structures the limited partners (investors) qualify as shareholders in a corporation that would receive dividends. In practice, a KGaA used to be most suitable for German-resident investors because they were able to benefit from the relevant dividend exemption regime (i.e., 95 per cent corporate tax exemption for corporate investors). This benefit largely vanished with the sunset of the participation exemption for investors with a shareholding of less than 10 per cent. The rules on minority shareholdings do not yet jeopardise the capital gains tax exemption, which is currently under discussion. For non-German resident investors, the KGaA was already in a non-tax-efficient structure. Managers of domestic KGaA should therefore consider restructuring (e.g., form change) into other legal forms.

iii The German Capital Investment Code

Scope of AIFMD/KAGB regulation

In general, all EU-managers of AIF are subject to the European AIFMD regulation. As mentioned above, the KAGB has implemented the AIFMD into German law. In this respect the KAGB provides for rules regarding the authorisation and regulation of the management company. Additionally, the KAGB provides for a specific product regulation regime referring to German AIF and states the requirements for the distribution of fund shares in Germany.

Manager regulation

Fund managers regulated by the KAGB have to apply for authorisation by BaFin to conduct their business.[4] The regulations require the implementation and specification of many functions, especially portfolio and risk management, but also the depositary function, the valuation function, compliance, internal audit, delegation, liquidity management, transparency and remuneration policies by the AIFM. Further, the AIFM must fulfil capital and substance requirements.

The KAGB has implemented certain rules that go beyond the European AIFMD regulation. One important example is the valuation of the AIF's assets.

Under the AIFMD the AIFM has to implement a valuation function that can be delegated to an external evaluator or – if certain requirements are met – internally conducted by the AIFM itself.

German legislation, however, differentiates between the pre-acquisition valuation (to ensure fair value valuation and market conformity of the transaction) and ongoing valuation for purposes of accounting and net asset value calculation. To ensure investor protection, German retail funds are subject to mandatory external pre-acquisition valuation.

Typical private equity fund assets, namely, private equity investments, co-investments or units or shares in AIF (target funds), may only be acquired when they are previously valued as follows: for assets of a value up to €50 million by one external evaluator, or for assets of a value of over €50 million by two external evaluators who perform the valuation of the assets independently of one another.

The external evaluator performing a pre-acquisition valuation may not also perform the annual (ongoing) valuation of assets during the holding period. All external evaluators must meet certain independence criteria. They may perform the function of external valuation for a maximum period of three years. The income of external evaluators resulting from their services provided to AIFMs may not exceed 30 per cent of their total income in their financial year. In addition, an AIFM may appoint the external evaluator again only after a two-year cooling-off period.

Beyond that, external evaluators must undergo a due diligence process according to the AIFMD regulations, and must be notified to BaFin. The performance of the ongoing valuation by an external evaluator qualifies as a delegation arrangement (as it is included as a function that an AIFM will generally perform in the course of the collective management of an AIF as defined in Annex I of the AIFMD) and must be treated as such.

4 This is different for EU fund managers that would like to enter the German market cross-border, for example; then the European passport rules for fund managers apply.

Product regulation

Differentiation between open-ended and closed-ended AIF

The AIFMD and the KAGB differentiate between open-ended and closed-ended AIF.

The distinction of whether an AIFM manages open-ended or closed-ended AIF is important, because the AIFMD and the KAGB require the AIFM to comply with particular requirements depending on the type of AIF it manages.

According to the European delegated regulation on the regulatory standards for determining types of funds,[5] an open-ended fund is any fund whose units or shares are, at the request of any of its shareholders or unitholders, repurchased or redeemed prior to the commencement of its liquidation phase or wind-down, directly or indirectly out of the assets of the fund. (However, a decrease in the capital in connection with distributions will generally not qualify a fund as open-ended.) Closed-ended funds are all other non-open-ended funds.

German product landscape

The KAGB has introduced a reform of the entire German product landscape, with restrictions on asset types for retail funds and specific product rules regarding open-ended and closed-ended special funds with professional and semi-professional investors.

The product rules of the KAGB also provide for a 'restriction of legal forms', meaning that a closed-ended fund has to be structured either as a closed-ended limited partnership or as an investment stock corporation with fixed capital. The latter vehicle would most probably be seldom used because of tax inefficiencies. This restriction of legal forms represents a theoretical disadvantage given the variety of other EU vehicles; however, the private equity industry should be able to accept the limited partnership structure as it is the most common legal form used in Germany anyway.

It is possible – exclusively for professional and semi-professional investors – to launch a German open-ended special fund that is generally allowed to invest in illiquid private equity assets using as a legal form either an open-ended limited partnership, an open-ended pool of separate assets or an open-ended investment stock corporation with variable capital. However, open-ended special funds for professional and semi-professional investors must be invested according to the principle of risk diversification and must provide for an (overall) asset portfolio with a liquidity profile that is in line with its redemption clauses.

Closed-ended retail funds provide for a specific catalogue of eligible assets; namely, an AIFM may only invest for a closed-ended retail AIF in tangible (real) assets; shares in public-private partnerships; shares in holding companies that may only acquire said tangible assets; participations in companies that are not admitted to trading on a stock exchange or traded on an organised market (private equity investments); units or shares in target AIF with similar investment policies; and some liquid assets and financial instruments. In addition, closed-ended retail funds must among others always be invested according to the principle of risk diversification and may only borrow up to a certain percentage calculated with respect to the fund's aggregated capital paid in by the investors.

The contractual terms of retail funds must be approved by BaFin, whereas the contractual terms of special funds for professional investors need only be notified.

5 Commission Delegated Regulation (EU) No. 694/2014 of 17 December 2013.

Marketing rules under the AIFMD and KAGB

Definition of marketing and distribution

The KAGB does not differentiate between private placement and public offering, but defines marketing and distribution as any direct or indirect offering or placement of fund shares to any type of investor. As an exception, if the distribution of the fund shares to professional or semi-professional investors in Germany does not take place at the initiative of the AIFM or on behalf of the AIFM (reverse solicitation), it does not qualify as marketing within the meaning of the KAGB. However, this reverse solicitation exemption is not stated in the law and is only common understanding of the Regulator. Hence, this approach should be handled very carefully and bears risks.

Notification process for marketing funds

In Germany, the notification process with BaFin is required for all funds to be marketed. This process is particularly burdensome for non-EU AIFMs. Until the implementation of the passport regime for non-EU AIFMs, a non-EU fund manager must provide sufficient evidence of compliance with the AIFMD and the KAGB respectively when applying for permission to market in Germany.

Every non-EU or EU AIFM has to go through a notification procedure with BaFin to market an AIF in Germany (inbound marketing). Minimum requirements of the notification letter are as follows:

a a business plan, including information on the AIF and the specified domicile of the AIF;
b contractual terms and legal documents of the AIF;
c name of the depositary; and
d a description of the AIF and all required information to be disclosed to investors (e.g., prospectus and key information document).

In addition, when marketing, the AIFM must use safeguards to prevent the marketing of special funds (set up exclusively for professional and semi-professional investors) to retail investors, such as notes in the prospectus, separate and restricted website portals, and relevant obligations in contracts with distribution partners.

As a prerequisite for marketing to German retail investors, the fund must be fully compliant with the KAGB regarding, inter alia, eligible assets, structure, investment restrictions and valuation.

Under the AIFMD passporting regime authorised EU fund managers will notify their national competent authorities (NCA) that they wish to market a fund to professional investors in another Member State of the EU and supply the required documents. Their NCA in turn contact the NCA of the targeted Member State to inform it of the intention to market. EU AIFMs authorised under the AIFMD must supply additional information on the KAGB-conformity of the fund if marketing to retail investors.

As a practical matter, the definition of marketing within the meaning of the KAGB depends generally on the existence of a specific AIF, namely an AIF that has been launched or trades under a definite fund name or whose contractual terms are definite and fixed. Consequently, AIFMs have to be careful in the pre-marketing phase to plan the timing of the notification process, which for a non-EU AIFM or a non-EU AIF may take a longer time.

Client classification

Given the fact that funds for professional and semi-professional investors are regulated less restrictively because of the lower level of consumer protection required compared to that for retail clients, it is necessary to decide in the pre-marketing phase which group of clients the fund shall be marketed to.

As a basis, the AIFMD has adopted the EU-wide applicable Markets in Financial Instruments Directive 2004/39/EC (MiFID) client categories, namely, the professional and retail client definitions used to achieve harmonised consumer protection in investment services.

To allow investors that are, for example, institutional but not professional to invest into professional funds, the KAGB has introduced a new client category – the semi-professional investor. With the introduction of the semi-professional investor the KAGB clearly deviates from the AIFMD and allows certain retail investors to be treated as professional investors – even if they cannot be upgraded under MiFID[6] criteria. This is good news for clients whose classification is disputed, such as trusts, foundations or family offices.

However, a retail investor may only be treated as a semi-professional investor if it fulfils the requirements that justify the lower level of protection. This is assumed to be justified if it makes a minimum investment of at least €10 million. Depending on who distributes, either the AIFM or its distribution partner is responsible for classifying the client.

For investments below the €10 million threshold, the AIFM (or its distribution partner) must ensure that the investor commits to making an initial single minimum investment of €200,000 in the AIF in question, an exemption threshold previously set out in Article 2 of the Capital Investment Act. This is to prove that the investor has sufficient financial resources to back its allocated risk appetite.

In addition, as with Article 6 of the EU Regulation on European venture capital funds (EuVECA),[7] the investor must state in writing, in a document separate from the contract to be concluded for the commitment to invest, that it is aware of the risks associated with the envisaged commitment or investment.

The AIFM (or its distribution partner) has to assess and obtain evidence that the investors has the expertise, knowledge and experience to independently assess the risks involved with the investment in the fund. If possessed of the relevant qualifications, the investor is deemed able to judge the suitability of the investment for itself. This, however, is based on the assumption that the investor is not as well versed in market knowledge and experience as the professional investor as defined under MiFID II.

If the AIFM (or its distribution partner) believes that the investor is able to make investment decisions itself and thus understands the inherent risks, and that the commitment is appropriate for the investor concerned, then the AIFM (or its distribution partner) must confirm in writing that the assessment has been performed and that these requirements have been met.

6 Now MiFID II (Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014).

7 Regulation (EU) No. 345/2013 of the European Parliament and of the Council of 17 April 2013.

Cross-border marketing implications

As the semi-professional investor is, from a MiFID II perspective, a retail client, funds containing semi-professional investors must be treated as retail funds and are subject to the national legislation of the individual Member States on marketing to retail investors. The possibilities of marketing these funds may be restricted if they are not compliant with the national legislation in question or if inbound notification procedures are not complied with. In addition, other Member States will most likely not foresee an outbound notification procedure for marketing to German semi-professional investors.

iv The German Venture Capital Companies Act

German private equity funds may consider registering under the German Venture Capital Companies Act (UBGG), which was introduced in 1998 and remains in effect even under the KAGB. Both laws are simultaneously applicable if the requirements are met and provided current activities are not grandfathered. KGs, KGaAs, GmbHs and AGs are eligible as a 'UBG fund'. The UBGG provides for partial tax transparency because UBG funds are exempted from German trade tax. However, UBG funds are restricted to a series of certain quotas that mainly aim to exclude holding companies from the benefits of the UBGG. For example, a UBG fund must not acquire majority shareholdings (i.e., not more than 49 per cent of the voting shares, subject to certain generous exemptions). In addition, the UBG fund must not invest more than 30 per cent in investments outside the EU or EEA. These restrictions practically limit the relevance of the UBGG mainly to a number of regional German mid-cap funds. However, the UBGG may be an interesting alternative for a German mezzanine fund, mid-cap fund or fund of funds.

v The EuVECA

Since 2013, the EuVECA has been directly applicable in all Member States to venture capital funds that are neither UCITS nor exceed the thresholds of the AIFMD, and where the AIFM (internal or external) is therefore only subject to registration with the NCA. The Regulation includes measures to allow qualified venture capital managers to market their funds to investors across the EU under a new 'European venture capital fund' label. The EuVECA sets out the requirements relating to the investment portfolio, investment techniques and eligible undertakings a fund must comply with. It also establishes categories of investors the funds may target; professional investors according to Annex II MiFID, or other investors that commit to investing a minimum of €100,000 and state in writing, in a separate document from the contract to be concluded for the commitment to invest, that they are aware of the risks associated with the envisaged commitment or investment.

III REGULATORY DEVELOPMENTS

On account of Brexit there will be changes in the European regulatory environment. UK or German entities currently using the European passport will have to change their actual structure. If the United Kingdom leaves the EU, we strongly expect that the European passport procedure for fund managers will no longer apply, as the United Kingdom will be regarded as a third country.

Moreover, because of the implementation of MiFID II,[8] which mainly affects the German Securities Trading Act and securities trading firms there will be changes to the KAGB, too, especially for German fund manager (branches or separate legal entities) that provide services or non-core services as defined by the AIFMD.[9]

IV TAX DEVELOPMENTS

The issues below, which might be relevant for fund taxation, have been addressed in the draft of the coalition agreement between the Christian Democratic Union, the Christian Social Union and the Social Democratic Party in February 2018:

a abolition of the flat tax regime on interest income through the establishment of a functioning automatic exchange of information;
b new initiatives should be developed together with France to adapt to the changes and challenges arising at an international level, including those involving the United States;
c support for a common tax base and for the introduction of minimum business tax rates at a European level;
d amendment of the Foreign Tax Act to meet modern demands;
e introduction of a financial transaction tax at a European level;
f more measures to combat tax evasion, tax avoidance, unfair tax competition and money laundering on a national, European and international level;
g implementation of obligations made under OECD BEPS;
h implementation of the EU Anti-Tax Avoidance Directive; and
i adaption of the interest-limitation rules and the introduction of regulations for hybrid entities.

The following issues have already been discussed in previous years but remain on the agenda for 2018 or even later:

a in keeping with similar practice for dividend taxation, abolishing the 95 per cent exemption on the sale of portfolio shareholdings (less than 10 per cent) has been suggested;
b the beneficial treatment of the carried-interest taxation might be abolished. Currently, the tax law provides for a beneficial tax regime that allows it to exempt 40 per cent of carried interest from taxation (see below); and
c there is a discussion on the abolishment of the solidarity surcharge.

Another reform effort that is worth mentioning is the promotion of venture capital in Germany to be internationally competitive as a location for venture capital investment. During the most recent legislative period the government launched measures to improve conditions for venture capital, as envisaged in the coalition agreement; however, new legislation was not adopted. How the reform will develop under the new government remains to be seen.

For each of these initiatives and legislative changes, private equity funds will have to carefully consider their acquisition structures for potential current and future tax exposures, and private equity managers will have to be more coordinated when structuring their investments in future.

8 Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014.
9 Directive 2011/61/EU of the European Parliament and the Council of 8 June 2011.

i The German Investment Tax Act

The new fund tax rules came into effect on 1 January 2018 and set out fundamental changes to investment taxation by replacement of fiscal transparency by an opaque tax regime. Furthermore, two regimes for fund taxation have been established – a transparent tax regime (for special funds if they opt for it) and an opaque tax regime (for non-special funds if they do not qualify as a special fund). In contrast to former legislation, the new German Investment Tax Act (ITA) provides for an expansion of the scope of application to cover all UCITS and AIF. However, the new rules only apply to German and international funds treated as corporations. Private equity funds in the legal form of partnerships – that are not UCITS – are not in the scope of the new ITA. General rules on the taxation of partnerships will continue to apply.

Thus, for managers of non-German private equity funds it is necessary to assess, if their legal set-up is comparable to a German partnership or corporation. The tax consequences may differ significantly depending on the result of this classification.

ii Taxation of private equity funds in the form of partnerships

German private equity funds in the legal form of partnerships and comparable foreign private equity funds are usually subject to the general German tax rules.

The taxation of partnership funds and their investors depends on the classification of the partnership as an asset management or (deemed) business partnership. Under German tax practice (case law), this qualification is based on facts and circumstances rather than on a specific status.

To claim asset management status, the fund vehicle or its general partner partnership should have a managing limited partner, which should be entitled to certain management responsibilities. This concept used to be internationally unique; however, it was recently introduced into Luxembourg partnership law to meet the needs of German individual investors in particular, carried-interest holders, or both. As noted above, BaFin currently seems to struggle with a managing limited partner acting alongside the AIFM. This uncertainty could trigger exits to Luxembourg, assuming the CSSF provides for more flexibility.

In addition, to be qualified as an asset management partnership, the actual investment activities of the fund vehicle have to comply with the catalogue of investment restrictions stated in a specific German tax guidance letter dated 2003. These restrictions used to be significantly stricter than those under the tax concepts of, for example, the United States or the United Kingdom. However, German funds have developed a high level of discipline to deal with the criteria and have often obtained tax rulings to address remaining uncertainties. In August 2011 the highest German federal tax court issued a decision that has caused some confusion as to whether the investment restrictions for a tax-transparent non-trading partnership would be even more restrictive than those in the German tax guidance letter from 2003 have so far been. In the current tax practice, a qualification of private equity funds according to the criteria listed in the tax guidance letter dated 2003 seems to prevail.

The taxation of asset management and business partnerships is different. Whereas an asset management partnership is, for example, basically regarded as tax-transparent, German partnerships that qualify as trading partnerships are subject to German trade tax. Furthermore, German individuals are generally taxed at a rate of 25 per cent (excluding solidarity surcharge) in cases of asset management partnerships, whereas income they receive from business partnerships is subject to their personal income tax rate of up to 45 per cent (excluding solidarity surcharge). However, capital gains from the sale of shares and dividends are 40 per cent tax-exempt. Corporate investors are principally subject to tax at an amalgamated corporate and trade tax rate of 30 per cent, varying slightly depending on the municipality in which the investor is seated. However, they are entitled to claim a 95 per cent participation exemption on capital gains from the sale of shares for corporate income tax (irrespective of the indirect holding percentage) and trade tax purposes (provided the holding is 15 per cent or higher). In addition, 95 per cent participation exemption can be claimed for dividends provided the indirect holding percentage exceeds 10 per cent.

Life and health insurers and pension schemes, which are not fully exempted from tax, are subject to full taxation on all types of income; however, they are entitled to build against the generally accepted accounting principles (GAAP) profit special reserves for insurance or pension liabilities, which effectively results in an effective tax rate of approximately 2 to 5 per cent. However, for these types of investors it is critical that the income recognition in the GAAP accounts is aligned with allocation of taxable income, as a mismatch could – in a given year – result in an effective tax rate of up to 30 per cent.

International corporate investors have raised concerns about investing in a German limited partnership because if the partnership qualified as a trading partnership, the investors would be subject to German tax-filing requirements and could effectively be taxed in Germany at a rate of approximately 30 per cent (on, for instance, income from interest or from hybrid instruments and dividends from minority shareholdings). These concerns are one reason why a thorough analysis and structuring of a German fund is absolutely necessary; often, a non-German fund might be the better option.

iii Taxation of corporate private equity funds

Corporate investment companies are, for example, closed-ended funds organised as a GmbH, German stock corporations or German investment stock corporations with fixed capital, and foreign entities comparable to these German entities. Commonly used corporate structures, such as the Luxembourg SA, Sarl or SICAV or the UK limited partnership that do not meet the criteria of an investment fund might be classified as corporate investment companies. This may also be true for a French FCPR, Italian *fondo chiuso*, Luxembourgish FCP or US investment trust.

Private equity funds in the legal form of corporations are within the scope of the revised ITA. Under the new opaque tax regime, corporate private equity funds are taxed as investment funds (mutual and retail funds), and are subject to corporate income tax of 15 per cent plus solidarity surcharge of 5.5 per cent with their German sourced income (i.e., dividends), German rents and gains from the sale of real estate, income from securities lending with German real estate. For German source income that is subject to withholding tax under German tax law, the applicable tax rate is 15 per cent, which will already be applied at source. Moreover, German funds can be subject to trade tax, depending on their structure and commercial activity. All other income, such as capital gains realised upon the sale of shares of German portfolio companies (other than real estate companies) and interest income, is not subject to German tax at the fund level. An exemption, however, does apply, if the objective business purpose is limited to the investment and management of assets.

If certain eligible investors are invested in the fund, an application for tax exemption from corporate tax is possible.

At the level of an investor the income is taxed upon distribution and transfer or redemption of fund units. In addition, investors are taxed on the part of the unrealised added value from non-distributed income accumulated during the year (dry income). No dry income will occur if the tax-opaque fund does not increase in value during a calendar year, or if the amount distributed to the German investors during a calendar year exceeds the computed dry income. For individuals that hold their investment interest as a private asset, the income is subject to flat tax regime (25 per cent plus surcharges). For investors that hold their investment as a business asset, the income is subject to tax at their personal tax rate. Corporate investors are subject to corporate income tax of 15 per cent (and eventually trade tax) plus solidarity surcharge of 5.5 per cent. The 95 per cent exemption for investment income is not applicable. With respect to investment proceeds from mixed funds, real estate funds and equity funds certain partial exemptions are applicable.

In the event that the German Controlled Foreign Corporation Rules (the CFC Rules) or Passive Foreign Investment Corporation Rules (the PFIC Rules) apply (e.g., if the foreign corporation does not qualified as an investment fund within the meaning of the ITA), they trigger taxation at the level of the German tax-resident investor on 'passive income' earned by the foreign corporate investment company, thus breaking down the tax shelter of retained profits. Passive income, in particular, comprises interest income as well as income and realised capital gains from debt instruments; such income will be fully taxable at the level of the investor. To avoid double taxation, dividends received from corporate investment companies and realised capital gains from the sale of shares in such companies are tax-exempt for the German investor to the extent that they were subject to prior CFC or PFIC taxation.

In practice, a participation of German investors in foreign corporate private equity funds will not seem appealing from a tax perspective. To prevent tax discrimination, existing corporate funds as well as new funds may consider setting up in an alternative form (such as a partnership). For Luxembourg vehicles, the newly introduced common limited partnership or special limited partnership may be an option.

iv VAT on management fees and priority profit shares

The management fee of a fund structured as a German limited partnership paid to its general partner or managing limited partner continues to be subject to German VAT at a rate of 19 per cent. The VAT exemption for investment funds under the ITA does not apply.

Until 2007, it was more tax-efficient to structure a priority profit share (PPS) scheme (comparable with the Anglo-American, Guernsey or Jersey structures). The PPS was expressly covered by the relevant tax guidance letter of the Federal Ministry of Finance dated 2003. The scheme provided that the priority profit share had to be sourced from profits calculated under the German commercial balance sheet rules, which, broadly speaking, allow the conversion of commitments into balance sheet reserves that can be dissolved for the benefit of balance sheet profits. However, the Federal Ministry of Finance changed its practice and requested in this context that the fund must be entitled to a repayment of the PPS in the event of a total loss or a lack of commercial profit. In most cases, private equity managers do not accept the offering of a repayment of the PPS to the fund and its investors, because private equity is a risk capital and such managers already share the risk by way of the 1 per cent co-investment that investors request from their managers. Moreover, a profit participation is not possible for externally managed funds, which pay the management fee to an external AIFM that is not an investor in the fund.

Consequently, private equity funds structured as a German limited partnership are subject to VAT on the management fee or the PPS, or both. More complicated structures may reduce the VAT leakage, but this depends on the facts and circumstances of each individual case.

It should be noted that the German government will monitor case law from the European Court of Justice and then examine whether this gives rise to scope for action that can be taken in line with EU law.

v Capitalisation of certain expenses

The German tax authorities take the view that the management fees and other professional expenses arising during the investment period should be capitalised as incidental acquisition costs related to investments in the tax balance sheet of the fund partnership. The same applies with regard to other expenses of the fund that are incurred in connection with the investments. The capitalised expenses would be pro rata allocated to investments acquired during a financial year, and they decrease capital gains upon disposal of the investments.

Because a direct allocation of the fees to individual investments can only be achieved through a complex calculation, the tax authorities have implemented different methods defining how and to what extent these costs are to be allocated to acquired assets and capitalised as incidental acquisition costs and the extent to which they have to be qualified, or requalified, into costs in connection with a disposal of assets and also be deductible first upon divestment of assets. Within a total investment period, the tax authority in Munich, for instance, stipulates the treatment of at least one instance of annual expenditure consisting of management fee, broken deal costs and other professional expenses as a non-deductible incidental acquisition cost of the investments. Additionally, at least one annual expenditure may only be deducted upon disposal of the investments as a divestment cost. The remaining expenditure that occurred during the investment period should be deductible.

On the other hand, the tax authority of Wiesbaden is of the opinion that such expenses have to be capitalised annually during the total investment period proportionately on the basis of the outstanding commitment at the end of the applicable year in relation to the fund's total commitment.

It should be noted that these practices have not yet been confirmed by any court decision or described in any formal decree of the Federal Ministry of Finance. Moreover, based on experiences from the tax audits, it is questionable whether the tax authorities will maintain their opinion in terms of the capitalisation methodology in future.

vi Carried-interest taxation

Under a specific carried-interest legislation, carried interest is taxed separately from the underlying investment component (e.g., the typical 1 per cent general partner share or co-investment) and qualifies as a service fee (and not as employment income) that is independent from the source of the profits (capital gain, dividend, interest). Under tight restrictions, described below, the service fee could be entitled to a 40 per cent exemption (meaning 60 per cent is taxed at 42 to 45 per cent, with an effective tax rate of up to approximately 28 per cent).

As mentioned earlier, the abolition of the beneficial carried-interest tax regime is being debated. The outcome depends on political discussions; it is currently difficult to predict whether (and when) the beneficial tax regime will be abolished. The 40 per cent exemption is designed for smaller German funds but should also apply in the context of large international buyout funds:

a non-trading fund vehicles – the relevant fund vehicle must qualify as an asset management (non-trading) partnership;

b full payout – the carried interest will be granted subject to a full payout of capital contributed by the investors. This condition may be difficult to apply on a deal-by-deal carried-interest structure;

c fund promotion – the carried-interest holders have to receive carried interest for their contributions to promote the purpose of the fund;

d private equity – the purpose of the fund is to acquire, hold and dispose of shares in corporations, which should cover private equity funds but may not include hedge funds or distressed funds, etc.;

e carried interest from a trading fund – the carried-interest legislation does not apply to trading funds. Nevertheless, there are strong arguments to apply the 40 per cent exemption to carried interest under the general exemption regime for capital gains and dividends; and

f carried interest from a corporate fund – the German tax administration issued a guidance letter under which dividends paid by a corporate private equity fund are not entitled to the 40 per cent exemption regime. We take the view that this guidance letter is not lawful, since the dividends are entitled to the general 40 per cent participation exemption unless anti-abuse legislation that provides for additional conditions would apply.

V OUTLOOK

Future fundraising for private equity funds in Germany will be dominated by the implementation of BEPS, the AIFMD and the corresponding tax reforms. Under the current provisions, fundraising with a non-German limited partnership should be most advantageous. Non-German funds not structured as limited partnerships but as FCPRs, *fondi chiusi*, FCPs, trusts or corporations (SICAVs) may suffer disadvantageous tax treatment, unless the tax provisions change significantly. Fundraising with a German limited partnership structure becomes increasingly difficult, even though it would be the most suitable entity to attack the large equity amounts required to finance future renewable energy and infrastructure projects in Germany. The revision of the ordinance for the investment of restricted assets of German insurance companies may have an effect on how funds must be structured to meet investors' requirements.

Finally, it should be noted that reliable tax planning seems difficult, and German fund taxation remains a field to be closely monitored by private equity fund managers and investors.

Chapter 6

HONG KONG

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I GENERAL OVERVIEW

Hong Kong is a leading international financial centre known for its strategic position as a hub and gateway to mainland China, as well as for being one of the world's largest capital markets. Hong Kong is also a principal private equity centre, ranking second in Asia after mainland China for total capital under management by private equity funds (excluding real estate funds), which amounted to US$161 billion in 2019.[2] The Hong Kong private equity industry is strengthened by its diversity. Long a preferred destination for global and regional investment fund managers, more than 200 managers were based in Hong Kong in 2019. For these reasons, Hong Kong is likewise an important jurisdiction for leading pension funds, insurance companies, sovereign wealth funds, family offices and other investors.

Hong Kong's asset and wealth management business posted strong growth in 2019 despite the challenges facing global markets. For example, the asset management and fund advisory businesses in Hong Kong amounted to HK$20,040 billion as at 31 December 2019, representing a significant increase of 22 per cent as compared to 2018. Furthermore, from September 2019 to September 2020, the number of corporations licensed in Hong Kong for Type 1 (dealing in securities), Type 4 (advising on securities) and Type 9 (asset management) regulated activities – the three types of licences most relevant to private equity fund managers – grew by 2 per cent, 7 per cent and 6 per cent, respectively.[3] Over the same period, the number of licensed representatives in Hong Kong for Types 1, 4 and 9 regulated activities slightly dropped by 3 per cent, increased by 2 per cent and increased by 3 per cent, respectively.[4]

The continued growth of the private equity sector in Hong Kong also reflects Hong Kong's important role in China's Belt and Road Initiative (BRI), one of Chinese President Xi Jinping's signature initiatives for global infrastructure investment. In addition, the rapid

1 Lorna Chen is a regional managing partner, Anil Motwani is an associate and Iris Wang is an associate at Shearman & Sterling.

2 See Asset and Wealth Management Activities Survey 2019, released by the Hong Kong Securities and Futures Commission (SFC) in August 2020, available at www.sfc.hk/-/media/EN/files/ER/Reports/AWMAS_2019_EN.pdf.

3 See Statistics on Number of Regulated Activities of Licensed Corporations, released by the SFC, available at www.sfc.hk/-/media/EN/files/SOM/MarketStatistics/c02.pdf.

4 See Statistics on Number of Regulated Activities of Licensed Representatives, released by the SFC, available at www.sfc.hk/-/media/EN/files/SOM/MarketStatistics/c04.pdf.

development of the Guangdong–Hong Kong–Macao Greater Bay Area (GBA) has created an additional need for private investment capital by start-ups in the innovation and technology field.

Hong Kong is well positioned heading into 2021, thanks in part to tax and legal changes initiated in the past few years by the Hong Kong authorities, including: the enactment of the Limited Partnership Fund Ordinance (LPFO) on 31 August 2020, to bring Hong Kong's limited partnership form in line with global standard; an expansion of the profit tax exemptions, to encourage the use of vehicles formed locally in Hong Kong; amendments to certain codes of conduct regulating fund managers, to strengthen investor confidence in the Hong Kong private funds market; and the tightening of regulation for funds investing in virtual assets, to support and promote responsible innovation.

In addition, during 2021 a legislative proposal has been introduced that provides special tax concessions for carried interest distributed by private equity funds operating in Hong Kong. Once adopted, these tax concessions should attract greater fund formation activity in Hong Kong, and further strengthen Hong Kong's position as a jurisdiction of choice for fund managers.

II LEGAL FRAMEWORK FOR FUNDRAISING

The Hong Kong Securities and Futures Commission (SFC) is the principal regulator of Hong Kong's securities and futures markets, including with respect to private equity fundraising. As empowered by Hong Kong's primary securities legislation, the Securities and Futures Ordinance (Cap 571) (SFO), the SFC performs a number of key functions central to the private equity industry, including licensing and supervising private equity managers and advisers, and setting and enforcing key regulations covering private equity fund management and the marketing of private equity fund interests in Hong Kong.

i Private placement of private equity fund interests in Hong Kong

Offerings in Hong Kong of interests in private equity funds structured as partnerships or trusts are subject to regulation under the SFO. Offerings in Hong Kong of shares or debentures issued by private investment funds structured as companies are subject to regulation both under the SFO and the Companies Ordinance.

Offering documents relating to securities offered to members of the Hong Kong public, whether offered by a licensed person or not, must be authorised by the SFC unless an exemption applies.

One of the most commonly used exemptions applies to offers made solely to 'professional investors' within the meaning of the SFO and its relevant subsidiary legislation. Professional investors broadly encompasses financial institutions, insurance companies, investment companies, retirement schemes, pension plans, government entities and certain high-net-worth individuals and large entities. If fund interests are marketed in Hong Kong, the relevant investors should be provided with a supplemental Hong Kong investor questionnaire to confirm and document their professional investor status. The admission by a fund of certain types of professional investor, including individuals, may cause such fund to be subject to enhanced compliance and due diligence requirements.

To the extent all Hong Kong offerees cannot meet the professional investor standard, another exemption is available under current market practices for offerings to not more than 50 offerees in Hong Kong. Although the offering documents for the types of private offers listed above are not required to comply with prospectus content requirements, they should include an appropriate securities legend to highlight that the offering documents have not been reviewed by any regulatory authority in Hong Kong and that investors are encouraged to seek independent professional advice.

The common structures for private equity funds with a managerial presence in Hong Kong are (1) fund entities formed as limited partnership funds (LPFs) in Hong Kong; (2) general partners formed either as limited partnerships or companies; and (3) investment managers or advisers established as companies in Hong Kong. Activities of an investment manager or adviser could, depending on the facts and circumstances, come within various categories of regulated activities under the SFO, including but not limited to (1) selling fund interests to residents in Hong Kong; (2) conducting selling activities in Hong Kong; (3) deal sourcing and execution of transactions; (4) making recommendations and advising with respect to potential deals; and (5) making investment decisions for the investment fund under management. As a result, any such Hong Kong investment manager or adviser entity would likely be required to obtain certain licences from the SFC. The offering of fund interests to investors in Hong Kong must be conducted by an appropriately licensed entity unless marketing takes place entirely outside Hong Kong.

ii SFC licensing regime

General requirements

Any company (or branch office of a foreign company) that carries on a business in a regulated activity in Hong Kong or holds itself out as carrying on a business in a regulated activity in Hong Kong is required to be licensed by the SFC, unless a specific exemption is available.

The SFO prohibits: (1) a person from carrying out a business in a regulated activity or holding himself or herself out as carrying on a business in a regulated activity without a licence; and (2) 'active marketing' of any services by any person (including those operating from offshore) to the public, directly or by another person on the person's behalf, if that would constitute a regulated activity if undertaken in Hong Kong, unless the person has obtained a licence.

The SFC guidance suggests that the following factors would be considered in reaching the conclusion that this 'active marketing' threshold has been crossed:

a there is a detailed marketing plan to promote the services;

b the services are extensively advertised via marketing means such as direct mailing, advertisements in local newspapers, or broadcasting or other 'push' technology over the internet (as opposed to where the services are passively available (e.g., on a take-it-or-leave-it basis));

c the related marketing is conducted in a concerted manner and executed in accordance with a plan or a schedule that indicates a continuing service rather than a one-off exercise;

d the services are packaged to target the public of Hong Kong (e.g., written in Chinese and denominated in Hong Kong dollars); and

e the services are sought out by the customers on their own initiative.[5]

5 See 'Actively markets' under Section 115 of the SFO, FAQ released by the SFC, available at www.sfc.hk/web/EN/faqs/intermediaries/licensing/active-marketing-under-section-115-of-the-sfo.html#1.

Regulated activity and relevant exemptions

The SFO stipulates 10 types of regulated activity, the most relevant of which for a private equity fund sponsor are Type 1 (dealing in securities), Type 4 (advising on securities) and Type 9 (asset management).

Type 1 (dealing in securities) regulated activity includes the making or offering to make an agreement with another person or inducing or attempting to induce another person to enter into an agreement for or with the view to acquiring or disposing of securities. If a company engages in the distribution and sale of securities, such as limited partnership interests or shares in a company, a Type 1 licence would thus be required. In addition, if a company engages in deal sourcing and the execution of private equity transactions, including negotiations with a target company, then this conduct may also constitute Type 1 regulated activity.

Type 4 (advising on securities) regulated activity includes the giving of advice on whether to acquire or dispose of securities. If a company provides investment advice for which remuneration is received, then, unless such advisory activities are wholly incidental to Type 1 regulated activity, the company will need to apply for and obtain a Type 4 licence.

Type 9 (asset management) regulated activity includes the managing of a real estate investment scheme or securities or futures contracts. If a company provides portfolio management services and exercises discretionary investment authority to make investment decisions for its clients, then the company will require a Type 9 licence.

As the profile of each private fund management team or sponsor with a managerial presence in Hong Kong may differ depending on such factors as strategy, personnel, business capabilities and operational models, many firms decide to apply for one or a combination of Type 1, 4 or 9 licences, while some other firms instead seek to rely on an exemption from the licensing requirements. Alternatively, some firms may choose to acquire a corporation that is already licensed and, through the acquisition, conduct the desired type of regulated activity. The SFO sets out various exemptions from the licensing requirements, the most relevant of which are profiled below.

Incidental exemption[6]

A company may not need a licence for certain regulated activities if these activities are performed in a manner that is wholly incidental to the carrying out of another regulated activity for which the company is already licensed. For example, if a company holds a Type 9 licence, then that company may rely on the incidental exemption to carry out related Type 1 and Type 4 regulated activities, provided that the preceding activities are undertaken solely for the purposes of the company's asset management business.

Group company exemption[7]

A company may not need a licence for Type 4 or Type 9 regulated activity if the company provides the relevant advice or services solely to the company's wholly owned subsidiaries, to the company's holding company, which holds all of the company's issued shares, or to other wholly owned subsidiaries of the company's holding company.

6 See SFC Licensing Handbook (July 2020) §1.3.3, §1.3.6.

7 See SFC Licensing Handbook (February 2019) §1.3.13.

Licensing criteria

Licence for the corporation[8]

The core principle behind the Hong Kong licensing regime is that applicants must demonstrate, to the satisfaction of the SFC, fitness and propriety[9] to be licensed. Being fit and proper involves, broadly, being financially sound, competent, honest, reputable and reliable.[10]

Certain attributes that a corporate applicant would generally have to satisfy to obtain an SFC licence are set out below.

Incorporation

The applicant must be either a company incorporated in Hong Kong or an overseas company registered with the Companies Registry of Hong Kong.

Competence

The applicant must prepare and submit several documents, including a shareholding chart, an organisational chart and operation flowcharts. The SFC revamped its licensing process in 2019 by introducing new licensing forms and mandatory electronic submission of annual returns and notifications. Key changes include introducing questionnaires regarding business profile and internal control summaries and requirements to include continuous professional training compliance confirmations in the annual return forms.

Responsible officers

The applicant must appoint at least two responsible officers (ROs) to be tasked with direct supervision of the conduct of each proposed regulated activity, with at least one RO being available at all times to supervise each of the proposed regulated activities[11] and at least one RO being designated as an executive director.[12]

In addition to ROs, any individual who carries on a regulated activity on behalf of the corporation will similarly be required to obtain a licence as a representative accredited to the corporation. Licensed representatives (LRs) may be accredited to more than one licensed corporation. As with ROs, LR applicants must satisfy the SFC that the LR has fulfilled the fit-and-proper requirement. All LR applicants must pass the competence test for a licensed representative.

In addition, all executive directors of the applicant must become ROs accredited to that applicant, and must seek and obtain the SFC's prior approval to do so.

8 Authorised financial institutions, such as banks, are required to be registered instead of licensed. This chapter is focused on issues relating to fully licensed corporations.

9 See SFO §129.

10 See SFC Licensing Handbook (July 2020), Fit and Proper Guidelines (October 2013), Guidelines on Competence (March 2003) and Guidelines on Continuous Professional Training (March 2003), issued by the SFC.

11 The same individual may be appointed to be an RO for more than one regulated activity, provided that this individual is fit and proper to be so appointed and there is no conflict in the roles assumed.

12 'Executive director' means a director of the corporation who (1) actively participates in or (2) is responsible for directly supervising, the business of a regulated activity for which the corporation is licensed.

Among other requirements, each RO applicant has to satisfy the SFC that the applicant has fulfilled the fit-and-proper requirements and has sufficient authority to supervise the business of regulated activity within the licensed corporation to which the RO applicant will be accredited.

Senior management

The senior management of the applicant must remain primarily responsible for ensuring the company's maintenance of appropriate standards of conduct and the company's adherence to procedures that facilitate compliance with those standards of conduct.

Substantial shareholders, officers and other related persons to be fit and proper

The applicant must ensure that all substantial shareholders,[13] officers[14] and any other person who is or is to be employed by, or associated with, the corporate applicant for the purposes of the regulated activity for which the application is made shall, likewise, be fit and proper.

Financial resources

The applicant must at all times maintain specified amounts of paid-up share capital and liquid capital in accordance with SFO requirements that depend on the licence type.

Insurance

If the applicant is a stock exchange participant seeking a Type 1 licence, the applicant must specify to the SFC that the applicant will take out and maintain insurance policies protecting against specific risks for specified amounts based on the SFC's approval of a master insurance policy applicable to the applicant.

Ongoing obligations

Licensed corporations, ROs and LRs must remain fit and proper at all times and comply with both the SFO and any other codes and guidelines issued by the SFC. Key ongoing obligations include:

a display of licence or certificate of registration;
b availability of ROs;
c notification requirements;
d submission of audited accounts;
e payment of certain annual fees; and
f continuous professional training.

13 'Substantial shareholder' means a person who, either alone or with his or her associates (1) has an interest in shares of the corporation with a nominal value of 10 per cent or more of the issued share capital or that entitles the person to exercise more than 10 per cent of the voting power at general meetings of the corporation, or (2) holds shares in any other corporation that entitles him or her to exercise 35 per cent or more of the voting power at the general meetings of the other corporation, or of a further corporation that is itself entitled to exercise more than 10 per cent of the voting power at the general meeting of the corporation.

14 'Officer' means a member of the senior management (including directors, ROs and 'managers-in-charge of core functions'), manager or secretary, or any other person involved in the management of the corporation.

iii Codes of conduct

In addition to the SFO, the SFC has issued other codes and guidelines that regulate licensed or registered persons, including the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (the Code) and the Fund Manager Code of Conduct (FMCC).

The Code applies to all licensed or registered persons in the course of their performance of the regulated activities for which they are licensed or registered. The Code sets out in detail certain fit-and-proper requirements that such persons must uphold to remain registered, including showing honesty and fairness, conducting and enabling due diligence, making proper disclosures and proper handling of conflicts of interest and client assets. Failure to comply with the Code would not directly and necessarily cause the relevant persons to become subject to legal action. However, the SFC will consider whether any such non-compliance would adversely affect the persons' status as being fit and proper to remain licensed or registered and, if so, may initiate an investigation using authority granted under the SFO.

The FMCC sets out further conduct and disclosure requirements for persons licensed by or registered with the SFC whose business involves the management of (1) authorised collective investment schemes, (2) unauthorised collective investment schemes, or (3) discretionary accounts. The FMCC, in this manner, supplements other codes and guidelines applicable to licensed or registered persons, including the Code, and emphasises and elaborates on certain existing requirements. Similarly to a breach of the Code, a breach of the FMCC would reflect negatively on a person's status as being fit and proper, and may create a basis for disciplinary action.

iv Taxation

The LPF is eligible for an exemption from Hong Kong profits tax on qualifying income. In addition, cash contributions and distributions to and from an LPF will not incur Hong Kong stamp duty.

III REGULATORY DEVELOPMENTS

The LPFO took effect on 31 August 2020. With the enactment of the LPFO, fund sponsors have the ability to form a streamlined fund structure with legal domicile, business operations and management personnel all in the single jurisdiction of Hong Kong, with resulting cost and other efficiency benefits. Going forward, we expect Hong Kong to be used more often by advisers and managers for the formation of the fund entities. As of the end of 2020, there were around 70 LPFs registered with the Hong Kong Company Registry.

During the course of 2020, a task force led by the Financial Services and the Treasury Bureau (FSTB) has examined and consulted with the industry at large regarding how tax concessions could be applied to carried interest distributed by private equity funds. The FSTB has proposed to Hong Kong's Legislative Council (LegCo) that eligible carried interest be charged at a profits tax rate of zero per cent and excluded from employment income for the purpose of calculating salaries tax. LegCo has discussed such proposal in January 2021, and it is anticipated that a final rule setting forth tax concessions for carried interest will be released soon.

IV OUTLOOK

Hong Kong, as Asia's leading financial centre and a major gateway to China, has attracted the interest of both domestic and international investors. The private equity industry in Hong Kong has experienced tremendous growth in the past decade. Faced with a growing number of participants and capital under management, on the one hand, and transforming technology and evolving global financial conditions on the other hand, Hong Kong is widely expected to develop and tighten regulations aimed at mitigating financial risks and keeping pace with regulatory developments in comparable international markets.

Recent years have seen the SFC increasing its efforts to fight irregularities in the private equity market and strengthen its scrutiny over fund managers on various aspects of their businesses, including the licensing requirement and approval process, the role of transfer pricing in a firm's managerial structure and the appropriate regulatory approach to investments in new industries. While Hong Kong is expected to maintain its historically competitive edge in terms of free trade, low tax and freedom of capital mobility, it will likewise continue to closely monitor and regulate the conduct of the private equity industry in a way that embraces and benefits from China's economic boom, the new global economy and growing financial integration.

Chapter 7

INDIA

Raghubir Menon, Ekta Gupta, Shiladitya Banerjee, Rohan Singh and Palak Dubey[1]

I GENERAL OVERVIEW

Despite the uncertainty of the global pandemic and its ensuing disruptions in the global economy, private equity investment in India in 2020 maintained the momentum of the previous year. In fact, the investments by private equity and venture capital investors stood at US$47.5 billion for the period from January to December 2020,[2] against US$47.3 billion during the same period last year. While the aggregate value of private equity (PE) deals seems largely unchanged, this belies the fact that US$17.298 billion, that is approximately 36 per cent of the aggregate capital raised by companies in India, was raised by Reliance Industries Limited group entities, especially in its technology, retailing and fibre arms. Moreover, PE exits fared much worse. In fact, exits by PE and venture capital firms fell to a six-year low in the first 11 months of 2020[3] with an estimated decline of 56 per cent compared to 2019.

India started the year by recording the slowest GDP growth rate in six years. In the wake of the pandemic, India's economy shrank by 7.5 per cent in the second quarter of the fiscal year 2020–2021 after seeing a record contraction of 23.9 per cent in the first quarter.[4] With the worst of the pandemic behind us, Moody's has raised its forecast for India's growth to –8.9 per cent for the calendar year 2020.[5]

Despite this slowdown, certain trends from 2019 continued into 2020. For instance, global PE and M&A investors continued to gravitate towards India and with ever-increasing investment values. The interest shown by sovereign wealth funds (SWFs) in India has continued on an upward trajectory, with SWFs from Abu Dhabi and Saudi Arabia having made some of the largest PE investments. Investors' focus remained fixed on control and corporate governance. During the first 11 months of 2020, almost all sectors recorded a significant decline in deal values with telecom, retail, education and pharma being the only sectors to record increase in value invested.[6] With respect to investments in the financial services sector, 2019's continuing crisis with non-performing assets (NPAs) had an adverse impact on investments in the financial services sector, which recorded a 43 per cent decline

1 Raghubir Menon and Ekta Gupta are partners, Shiladitya Banerjee is a principal associate and Rohan Singh and Palak Dubey are associates at Shardul Amarchand Mangaldas & Co.
2 www.forbesindia.com/article/vc-and-pe-special/2020-a-big-deal-year-for-pe-vcs/65699/1.
3 www.livemint.com/news/india/pe-vc-exits-plunge-to-six-year-low-on-covid-impact-11608484235949.html.
4 www.financialexpress.com/economy/q2-gdp-live-economy-growth-slowdown-recession-recovery-manufacturing-services-trade-forex-industrial-output-core-sector-july-september-2020/2137913/.
5 https://economictimes.indiatimes.com/news/economy/indicators/moodys-revises-india-forecast-for-the-calendar-year-2020-to-8-9/articleshow/79186213.cms.
6 www.ey.com/en_in/private-equity/pe-vc-monthly-roundup.

in investment values as compared to 2019.[7] In addition, the Reliance Group attracted investments from PE investors and SWFs, especially in its technology and retailing arms, namely: Jio Platforms Limited and Reliance Retail Ventures Limited, of an aggregate amount of US$17.3 billion representing approximately 36 per cent of all PE/venture capital (VC) investments in 2020.[8] Lastly, several new India-focused funds were set up in 2020 despite the slowdown. SAIF Partners (rebranded as Elevation Capital) has created a new fund, SAIF Partners India VII Ltd, valued at approximately US$400 million.[9] In September 2020, Lightspeed India Partners raised US$275 million for its new fund.[10] Meanwhile, Blume Ventures, a home-grown VC firm, raised US$102 million, the first Indian fund to exceed the US$100 million milestone.[11]

i 2020 versus 2019

The year 2020 started on a grim note with news of the global outbreak of covid-19 followed by the stipulation of lockdowns and restrictions on travel and usual business activities resulting in a severe disruption in the investment landscape in India. Nevertheless, Indian companies managed to raise an aggregate sum of US$47.5 billion from PE investors during 2020.[12]

However, of the above-mentioned figure, nearly US$17.298 billion (i.e., almost 36 per cent of the aggregate investment value) was because of investments in Reliance group entities.[13] This sluggishness in PE fundraising is in stark contrast to the trend in the VC sector, where global and domestic limited partners (LPs) pumped a substantial amount of money into India-focused VC funds in 2019.[14]

ii Industry sector trends

In 2020, investments in the education-technology and pharmaceuticals space dominated fundraising activity in India. In this context, the top three deals in terms of valuation (excluding Reliance) are in the pharmaceuticals space. On the other hand, investment in the real estate and infrastructure sector lagged behind with an aggregate investment of US$10.17 billion across 61 deals, compared to US$19.88 billion across 121 deals.[15] However, a key highlight of the telecom infrastructure in 2020 was the aggregate investment of US$1.01 billion by the Abu Dhabi Investment Authority and the Public Investment Fund of Saudi Arabia, for acquiring a majority stake in Digital Fibre Infrastructure Trust, a registered infrastructure investment fund in India, that operates an optic fibre cable network of nearly 17.37 million fibre pairs per kilometre across India, through its special purpose vehicle.[16]

7 www.livemint.com/companies/news/india-records-80-billion-of-m-a-and-private-equity-deals-in-2020-report-11608707978674.html.
8 www.forbesindia.com/article/vc-and-pe-special/2020-a-big-deal-year-for-pe-vcs/65699/1.
9 www.vccircle.com/saif-partners-rebrands-as-it-marks-final-close-of-new-fund-loses-md.
10 www.vccircle.com/paytm-backer-saif-partners-aims-at-larger-corpus-for-new-india-fund/.
11 www.vccircle.com/saif-partners-rebrands-as-it-marks-final-close-of-new-fund-loses-md.
12 ibid.
13 ibid.
14 www.vccircle.com/flashback-2019-vcs-snag-record-sum-as-pe-firms-toil-hard-to-cross-finish-line.
15 www.forbesindia.com/article/vc-and-pe-special/2020-a-big-deal-year-for-pe-vcs/65699/1.
16 www.livemint.com/companies/news/india-records-80-billion-of-m-a-and-private-equity-deals-in-2020-report-11608707978674.html.

iii Consumer, technology and financial services

The telecom sector attracted investments worth US$11.2 billion, with the retail sector attracting investments worth US$6.5 billion. Meanwhile, the technology sector recorded a total investment value of just under US$6 billion. Online service aggregators accounted for the majority of the investments in the technology space. In the education-technology sector, Byju's secured funding of over US$1.25 billion from a slew of VC funds, hedge funds and asset management firms, including Silver Lake Partners, Owl Ventures and Tiger Global.[17]

iv Early stage

PE and VC investors have invested approximately US$10.6 billion into Indian start-ups in 2020 across 60 deals despite the slow-down caused by covid-19.[18] In fact, in December, more than US$1.5 billion was invested across companies including food delivery app Zomato (US$660 million from 10 investors) and InMobi's mobile-content platform Glance (US$145 million from Google).[19]

These figures pale in comparison to 2019 where domestic start-ups had raised a total of US$14.2 billion across 1,482 investment rounds. However, the amount raised in 2020 was higher than 2016 and 2017.[20] In addition, nearly a year after announcing that the Indian government was working on a seed fund for start-ups, Prime Minister Narendra Modi announced the launch of a 10 billion rupees 'Startup India Seed Fund' for fuelling the creation of new start-ups and early stage ventures. He also announced that the government would assist start-ups in raising debt capital, without revealing additional details.[21]

v Real estate and infrastructure

Real estate investments in India slowed down in 2020, with a total deal value of US$4.06 billion. However, more than half of the investment value comes from Brookfield and Mitsui's investments in RMZ Corporation.[22] Excluding these deals, the real estate and infrastructure sector fared poorly compared to 2019. In 2020, this sector recorded an aggregate investment value of $10.17 billion across 61 deals, compared to only US$19.88 billion in 2019, showcasing a drop of almost 49 per cent.[23] Towards the end of the year, the momentum picked up as global investors like Blackstone Group and Brookfield Asset Management acquired commercial assets in India as developers sold some key properties to deleverage their balance sheets. For instance, Brookfield acquired Bengaluru-based RMZ Corp's 12.5 million square feet assets for nearly US$2 billion.[24]

17 www.thehindu.com/business/byjus-raises-fresh-funding-from-silver-lake-others/article32550406.ece.

18 www.livemint.com/companies/start-ups/byjus-zomato-corner-bulk-of-startup-funds-in-pandemic-year-11609347519888.html.

19 https://theworldnews.net/in-news/investors-pour-9-3-billion-into-indian-startups-a-decline-as-compared-to-2019-data-shows.

20 www.firstpost.com/business/investors-pour-9-3-billion-into-indian-startups-a-decline-as-compared-to-2019-data-shows-9152251.html.

21 www.deccanherald.com/business/pm-narendra-modi-announces-rs-1000-crore-startup-india-seed-fund-939845.html.

22 www.livemint.com/companies/news/india-records-80-billion-of-m-a-and-private-equity-deals-in-2020-report-11608707978674.html.

23 www.forbesindia.com/article/vc-and-pe-special/2020-a-big-deal-year-for-pe-vcs/65699/1.

24 https://realty.economictimes.indiatimes.com/news/industry/rmz-sells-12-5-million-sq-ft-real-estate-assets-to-brookfield-for-2-billion/78760809.

vi Healthcare

The healthcare sector has arguably received the most attention from PE investors in 2020. In this context, the top three deals in terms of valuation (excluding Reliance) are in the pharmaceuticals space. This includes New Mountain Capital's acquisition of Aurobindo Pharma's US unit for US$550 million, KKR's acquisition of 65 per cent in the listed API manufacturing firm JB Chemicals for US$496 million and Carlyle Investment Management's investment of US$490 million in Piramal Pharma for acquiring a 20 per cent stake.[25] In the hospital sector, two major transactions were the acquisition of majority stake in HealthCare Global Enterprises by CVC Capital Partners for US$140 million[26] and the acquisition of Columbia Asia Hospitals by Manipal Hospitals for an estimated US$240 million to 280 million.[27]

vii Exits

Exits were the most affected by the slowdown in PE/VC deal activity. The first 11 months of 2020 recorded 35 buyouts valued at approximately US$8.7 billion as compared to 58 buyouts valued at US$16 billion for the corresponding period in 2019, being the lowest value in six years for the period under consideration. The same trend was reflected in open market exits as well. During this period, exits via open market accounted for 59 deals valued at approximately US$2.3 billion recording a 47 per cent decline compared to same period in 2019.[28] That being said, approximately 55 per cent of the money raised via initial public offerings (IPOs) in 2020 (approximately US$2.3 billion) were meant for PE or VC exits.[29] As the primary markets recouped after a three-month lull due to covid-led disruptions and volatile stocks, public listing of companies received huge participation in 2020. However, most of the money raised through IPOs was used to provide an exit to private equity players or existing shareholders.

Around 55 per cent of the money raised via IPOs in 2020 was meant for private equity or venture capital exits, which is at least at a five-year high compared to 24.36 per cent, 29.09 per cent and 26.72 per cent in 2019, 2018 and 2017, respectively, according to data from Prime database.

Beating covid-led business uncertainties, 15 IPOs raised an aggregate amount of 266.11 billion rupees this year, up 115 per cent compared to the 123.62 billion rupees raised via 16 IPOs in 2019.

This downturn is unsurprising given the disruptive impact of covid-19 on the global economy. In 2020, PE investors have been reluctant to exit given the likelihood of sub-optimal returns on their investments and the promise of a better economic outlook in 2021.

25 www.forbesindia.com/article/vc-and-pe-special/2020-a-big-deal-year-for-pe-vcs/65699/1.

26 https://economictimes.indiatimes.com/markets/stocks/news/cvc-capital-to-buy-cancer-chain-hcg-for-rs-1049-crore/articleshow/76190987.cms.

27 https://health.economictimes.indiatimes.com/news/pharma/online-pharmacies-emerged-as-one-of-the-most-active-healthcare-sub-sectors-in-2020/80018768.

28 https://assets.ey.com/content/dam/ey-sites/ey-com/en_in/topics/private-equity/pe-vc-monthly-roundup/2020/ivca-ey-monthly-pe-vc-roundup-for-november-2020.pdf.

29 www.hindustantimes.com/business-news/ipos-in-2020-dominated-by-pe-exits/story-bHxdPhIcmWrIQC0bzHOn0H.html.

One of the most significant exits of 2020 is the US$1billion partial exit by Carlyle through the IPO of SBI Cards, where it sold 10 per cent of its stake.[30] Other notable exits by PE firms included Blackstone's partial stake sale in the Embassy REIT[31] and in packaging firm Essel Propack Ltd.[32] In the technology sector, two notable exits included Nexus India Capital, Jungle Ventures and Naspers selling their stake in Paysense Services India for US$293 million[33] and Warburg Pincus's secondary deal in Ecom Express for US$250 million.[34] However, generally speaking exits were adversely affected in light of the reduced valuations of investee companies on account of the uncertainty of covid-19.

viii Reception by LPs and fund managers

According to a market survey conducted by the Emerging Markets Private Equity Association in 2020, India was ranked third in the category of 'perceived attractiveness of emerging markets for private capital'. India, after China, leads other emerging markets in the share of commercial institutions currently investing or planning to invest in venture capital opportunities, at 70 per cent, which is reflective of India's massive customer base. In terms of disadvantages, investors have cited high entry valuations, weak exit environments, currency risks and historical performance as some of the deterrents to investments in India. However, concern around oversupply of funds or an over-competitive environment appears to have been reduced drastically compared to 2019, possibly as a consequence of the global pandemic.[35]

II LEGAL FRAMEWORK FOR FUNDRAISING

i Offshore structures

Foreign investors have always opted for a jurisdiction that provided tax neutrality to them with respect to their investments in India. Under the Indian tax regime, a non-resident investor is subject to tax in India if it receives or is deemed to receive income in India; or income accrues or arises or is deemed to accrue or arise in India. However, if the non-resident is based out of a jurisdiction that has entered into a double-taxation avoidance treaty (DTA) with India, the taxation implications are nullified and the Indian income tax laws apply only to the extent they are more beneficial than the tax treaties. Accordingly, most India-focused funds are based out of either Singapore or Mauritius as a limited liability partnership (LLP) or a corporate entity. Further, the general partner (GP) and the investment manager, who set up and operate the investment vehicle, are located outside India.

ii Tax risks re offshore structures

To curb tax avoidance, the government introduced the General Anti-Avoidance Rule (GAAR), with effect from the financial year beginning on 1 April 2017. The introduction of the GAAR has provided the tax authorities with the ammunition to re-characterise a transaction or an arrangement such that it gets taxed on the basis of substance, rather than

30 www.carlyle.com/media-room/news-release-archive/carlyle-group-completes-partial-exit-sbi-card-through-ipo.
31 https://realty.economictimes.indiatimes.com/news/industry/blackstone-raises-around-rs-2270-crore-from-stake-sale-in-embassy-office-parks-reit/76564664.
32 www.avcj.com/avcj/news/3021085/blackstone-makes-usd253m-part-exit-from-indias-essel-propack.
33 www.ey.com/en_in/private-equity/credit-investments-are-a-fast-emerging-asset-class-for-pe-vc-investments.
34 www.avcj.com/avcj/news/3022214/partners-group-invests-usd250m-in-indias-ecom-express.
35 www.empea.org/app/uploads/2020/06/FINAL-2020-EMPEA-Global-LP-Survey-06.25.20-web.pdf.

on its form. The consequences include investment vehicles being denied DTA benefits or reclassification of capital gains as any other income, or a combination of these. In addition, the government amended the criteria for determining the tax residence of offshore companies by introducing the place-of-effective-management (POEM) guidelines, with effect from 1 April 2017. According to the POEM guidelines, if the key management and commercial decisions that are necessary to conduct the business of any entity as a whole are, in substance, made in India, an offshore entity could be construed as being tax resident in India.

The past years also witnessed India renegotiating its DTA agreements with Singapore and Mauritius, making these less attractive as fund jurisdictions. The details of these changes along with an analysis on the future of these countries as viable fund jurisdictions is set out in detail in Section II.vi.

India has also ratified the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI), pursuant to which several of its DTA agreements now include anti treaty abuse rules.

iii Rise of unified structures with direct investment by LPs

The fear of tax exposure owing to the various changes set out above has led to investors exploring unified structures or co-investment structures. Under the unified structure, both domestic and foreign investors make their investments into a domestic pooling vehicle. These unified structures received a huge impetus in 2015.

Until 2015, these investment vehicles were heavily funded by domestic investors because prior permission from the Foreign Investment Promotion Board was required if the overseas funds intended to directly invest in a privately pooled vehicle in India. To increase the participation of offshore funds in these investment vehicles, since November 2015, the Reserve Bank of India (RBI) has permitted such investment vehicles to receive investments from non-resident Indian investors and foreign investors through the automatic route, as long as control of the investment vehicles vests in the hands of sponsors and managers, or investment managers, that are considered Indian-owned and controlled under the extant foreign regulations; investments by Indian-controlled alternative investment funds (AIFs) with foreign investment are thus deemed to be domestic investments.

iv Legal framework of domestic funds

Alternative investment funds

Prior to private equity capital gaining popularity, entrepreneurs relied heavily on loan capital raised from banks and financial institutions, public issuances and private placements. Realising the potential role of PE funds and the value addition they would contribute to the growth of corporate entities, the Securities and Exchange Board of India (SEBI) introduced a set of regulations governing investments by VC investors. This was followed by an overhaul in the regulations in 2012 with the introduction of the SEBI (Alternative Investment Funds) Regulations 2012 (the AIF Regulations) to regulate privately pooled investment vehicles that collect funds from investors on a private placement basis. The AIF Regulations replace the earlier regulatory framework of the SEBI (Venture Capital Funds) Regulations 1996, which covered funds that primarily invested in unlisted VC undertakings.

Under the AIF Regulations, an AIF is a privately pooled investment vehicle incorporated in the form of an LLP, trust or body corporate, which collects funds from Indian and foreign investors for investments in accordance with a defined investment policy for the benefit of its investors.

Based on the nature of the funds and their investment focus, the AIF Regulations categorise funds into Category I AIF,[36] Category II AIF[37] and Category III AIF.[38] These categories of funds must also comply with distinct investment conditions and restrictions during their life.

The AIF Regulations prescribe, inter alia, a cap of 1,000 on the number of investors pooling into the AIF, conditionality on the minimum corpus for the fund and a minimum amount to be invested by an investor. To align the interests of the investors and the promoters or sponsors of the fund, the sponsor or manager of the AIF is required to have a continuing interest in the AIF throughout the life of the AIF. Further, investment by the sponsor or manager of a Category I AIF or Category II AIF has to be at least 2.5 per cent of the corpus (at any given point) of the AIF or 50 million rupees, whichever is lower. The continuing interest in the case of a Category III AIF has to be at least 5 per cent of the corpus or 100 million rupees, whichever is lower.

Before commencing operations, AIFs should register with SEBI, which takes about four to six weeks. An AIF can be set up in the form of a trust, a company, an LLP or a body corporate. Most funds in India opt for the trust structure. The entities involved in the structure are a settlor, a trustee and a contributor. The settlor settles the trust with a small amount as an initial settlement. The trustee is appointed to administer the trust and is paid a fee in lieu of such services. The investor signs up to a contribution agreement or a subscription agreement to make a capital commitment to the fund.

Sector-focused fund structures

Real estate investment trusts and infrastructure investment trusts

In 2014, SEBI notified the Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations 2014 (the REIT Regulations) and the SEBI (Infrastructure Investment Trusts) Regulations 2014 (the Infrastructure Regulations) to regulate investments in the real estate and infrastructure sectors respectively. An infrastructure investment trust (InvIT) and a real estate investment trust (REIT) must register with SEBI to conduct their business.

A REIT is a trust formed under the Indian Trust Act 1882 (the Trust Act) and registered under the Registration Act 1908 with the primary objective of undertaking the business of real estate investment in accordance with the REIT Regulations and has separate persons designated as sponsor,[39] manager and trustee. The REIT is created by the sponsor of the trust, the trustee oversees the entire REIT and ensures all rules are complied with, and the beneficiaries are the unitholders of the REIT. The parties involved in the establishment of the REIT are: (1) the sponsor; (2) the trustee; (3) the investment manager and (4) the

36 An AIF that invests in start-up or early-stage ventures, social ventures, small and medium-sized enterprises (SME), in infrastructure or other sectors or areas that the government or regulators consider socially or economically desirable (including VC funds, SME funds, social venture funds, infrastructure funds, angel funds and such other AIFs as may be specified).

37 An AIF that does not fall into Category I and III and does not undertake leverage or borrowing other than to meet day-to-day operational requirements and as permitted under the AIF Regulations will be a Category II AIF.

38 An AIF that employs diverse or complex trading strategies and may employ leverage including through investment in listed or unlisted derivatives will be a Category III AIF. AIFs such as hedge funds or funds that trade with a view to making short-term returns or other open-ended funds can be included.

39 A sponsor is a person who sets up a REIT and is designated as such at the time of application made to SEBI. It also includes an inducted sponsor.

valuer. Each sponsor of a REIT is required to have a net worth of not less than 250 million rupees and a collective net worth of not less than 1 billion rupees. The sponsor should have not less than five years' experience in the development of the real estate sector. The trustee is the owner of the REIT assets, which it holds for the benefit of the unitholders, and it oversees the activities of the manager. The investment manager enters into an investment management agreement with the trustee and makes the investment decisions for the REIT. The responsibility of the valuer is to conduct half-yearly and annual valuations of the REIT's assets. The REIT Regulations impose a restriction on a REIT to invest only in its holding company, special purpose vehicles (SPV) or properties or transfer development rights in India or mortgage-backed securities. A REIT is allowed to make an initial offer of its units only through a public issue. No such offer can be made unless the offer size is at least 2.5 billion rupees and the value of the assets is not less than 5 billion rupees.

Akin to a REIT, an InvIT is a trust formed under the Trust Act and registered under the Registration Act. The InvIT is created by the sponsor of the trust, the ownership of the property vests in the trustee and the beneficiaries are the unitholders of the InvIT. It should be ensured that no unitholder of an InvIT enjoys superior voting rights or any other rights over another unitholder. Further, the Infrastructure Regulations prohibit multiple classes of units of InvITs. The Infrastructure Regulations require that an InvIT must hold not less than 51 per cent of the equity share capital or interest in the holding company or project SPVs. The parties involved in the establishment of the InvIT are: (1) the sponsor; (2) the trustee; (3) the investment manager; and (4) the project manager. The sponsor is responsible for the creation of the trust. The trustee is the owner of the InvIT assets, which it holds for the benefit of the unitholders. While the investment manager makes the investment decisions for the InvIT, the project manager is responsible for achieving the execution or management of the project in accordance with the Infrastructure Regulations. The Infrastructure Regulations further require that the investment manager, in consultation with the trustee, is required to appoint the majority of the board of directors or governing board of the holding company and SPVs.

Both Infrastructure Regulations and the REIT Regulations include conditions on investment and borrowing powers, the process for listing and trading of units, net worth and experience requirements, rights and obligations of different entities involved and the valuation of assets and the distribution policy.

In 2017, the RBI permitted banks to participate in REITs and InvITs within the overall ceiling of 20 per cent of their net owned funds for direct investments in shares, convertible bonds or debentures, units of equity-oriented mutual funds and exposure to venture capital funds (VCFs) both registered and unregistered, subject to the following conditions: (1) the banks must have put in place a board-approved policy on exposure to REITs or InvITs specifying the internal limit on such investments within the overall exposure limits in respect of the real estate sector and infrastructure sector; (2) not more than 10 per cent of the unit capital of a REIT or InvIT can be invested by the banks; and (3) the banks must adhere to the prudential guidelines of the RBI, as applicable.

In October 2019, the RBI further permitted banks to lend funds and extend credit facilities to InvITs subject to certain conditions, including: (1) the banks must have adopted a board-approved policy on exposures to InvITs specifying, inter alia, the appraisal mechanism, sanctioning conditions, internal limits and monitoring mechanism; (2) the banks can only lend to such InvITs where none of the underlying SPVs, having existing bank loans, is facing a 'financial difficulty'; (3) bank finance to InvITs for acquiring equity in other entities will be subject to the RBI guidelines, as applicable; and (4) the banks must undertake an assessment of all critical parameters to ensure timely debt servicing. Such availability of credit to InvITs is a welcome move as it will encourage investments into and by InvITs.

In November 2018, SEBI amended the guidelines for public issues of REIT and InvIT units with a view to further rationalising and easing the issue process. 2019 witnessed further amendments to the REIT Regulations and Infrastructure Regulations. Some of the key changes include a reduction in the minimum subscription from any investor in any publicly issued InvIT from 1 million rupees to 100,000 rupees. In the case of a publicly listed REIT, the minimum subscription amount has been reduced from 200,000 rupees to 50,000 rupees. In addition, the minimum trading lot has been reduced from 500,000 rupees to 100,000 rupees. Prior to the 2019 amendments, the aggregate consolidated borrowings and deferred payments of a listed InvIT, its holding company and SPVs were capped at 49 per cent of the value of InvIT assets, which restricted the ability of InvITs to make further acquisitions and provided for limited returns as compared to AIFs. Such limit has now been increased to 70 per cent of the value of InvIT assets subject to certain conditions such as obtaining a prior approval of 75 per cent of the unitholders and utilisation of funds only for the purpose of acquisition or development of the infrastructure projects or real estate projects. Unlisted private InvITs received a relaxation of the rules in terms of the minimum number of investors, which is now at the discretion of the InvITs (capped at 20 members). The leverage limit of these private InvITs needs to be specified under the trust deed (in consultation with the investors). In 2020, certain amendments were introduced to the REIT Regulations and Infrastructure Regulations, details of which are set out in Section VII.iii.

Currently, there are two public InvITs, six privately placed InvITs and two listed REITs. In March 2020, SEBI granted temporary relaxations in compliance requirements for REITs and InvITs owning to the impact of the covid-19 pandemic, details of which are set out in Section VII.iii.

v Steps to popularise domestic funds as fund structures

Over the past year, the government has taken steps for mobilising domestic capital from banks, mutual funds and insurance companies. In fact, the Alternative Investment Policy Advisory Committee in its report submitted on 19 January 2018 recommended the use of domestic funds as they currently constitute only a minor percentage of the total funds invested annually. Under a domestic fund structure, the fund vehicle (typically a trust entity registered with SEBI as an AIF) is treated as tax pass-through subject to certain conditions. The income earned is taxable in the hands of the investors directly. Further, the characterisation of income in their hands is the same as that realised or distributed by the investee company to the fund. On 3 July 2018, SEBI raised the cap for overseas investments in AIFs and VCFs from 36,457.7 million rupees to 54,686.6 million rupees. Investments in AIFs in 2019 rose 53 per cent over 2018, to 1.4 trillion rupees.[40] Further, a restriction on allocating foreign portfolio investors (FPIs) to more than 50 per cent of the securities in a single debt issuance prompted FPIs to use the AIF route to make debt investments into India. In 2020, despite the pandemic-led disruptions, AIFs raised commitments worth more than 350 billion rupees in the first half of the financial year ending on 31 March 2021 (majorly by Category II

40 www.business-standard.com/article/pti-stories/aif-investment-rises-to-rs-1-4-lakh-cr-in-dec-quarter-120021301028_1.html.

AIFs), which is marginally more than the amount raised in the year-ago period. Even the registrations of new funds appears to have picked up after the initial impact of the pandemic subsided.[41]

vi Preferred jurisdictions for offshore funds

Background

The primary driver that determines the choice of jurisdiction for setting up India-focused funds is a domicile that has executed a DTA with India. Currently, India has separate DTA agreements with various countries, such as Ireland, Mauritius, the Netherlands and Singapore. The Netherlands has been a popular jurisdiction primarily with portfolio investors. This is because the capital gains tax benefit is available to Dutch entities on sale of shares of an Indian company to a non-resident and, on sale of such shares to an Indian resident as long as they hold less than 10 per cent of the shares of such Indian company.

Over the years, Mauritius has been one of the most favoured destinations to set up India-focused funds and accounts for more than 30 per cent of the foreign investment into India. This is because India's DTA with Mauritius that provided a capital gains exemption, on sale of shares of an Indian company. While the India–Singapore DTA had a similar exemption, it was subject to satisfaction of certain conditionalities, popularly known as the limitation-of-benefits clause.

Recent treaty changes

The DTA between India and Mauritius was amended on 10 May 2016 pursuant to a protocol signed between the respective governments (the Mauritius Protocol). Pursuant to the Mauritius Protocol, the capital gains tax exemption is being phased out and any capital gains arising from sale of shares (acquired after 1 April 2017 and transferred after 31 March 2019) will be taxable in India at the full domestic rate. Further, shares acquired after 31 March 2017 and transferred before 31March 2019 will be taxed at 50 per cent of the domestic tax rate of India subject to certain conditions. This phasing out of the capital gains exemption is only applicable to sales of shares and not sales of debentures. Accordingly, sales of debentures continue to enjoy tax benefits under the India–Mauritius DTA, making Mauritius a preferred destination for debt investments.

Further, prior to the Mauritius Protocol, India did not have the right to tax any residuary income of a Mauritian tax resident arising in India. The Mauritius Protocol has now enabled India to tax 'other income' arising from a Mauritian tax resident in India. In addition, the Financial Services Commission of Mauritius has introduced domestic substance rules to determine whether Mauritius-based entities are managed and controlled in Mauritius. India and Mauritius have also agreed to assist each other to collect revenue claims, upon a request from each other's revenue authorities. All such measures, viewed cumulatively, signal India's serious resolve to curb tax avoidance.

The amendments to the India–Mauritius DTA have made it a significantly less popular destination for making investments. Taking its cue from the Mauritius Protocol, the respective

41 www.livemint.com/news/india/aifs-keep-pace-year-on-year-raise-commitments-worth-rs-35-000-crore-in-fy21h1-11605773228280.html.

governments of India and Singapore signed a protocol amending the India–Singapore DTA on similar lines, introducing source-based taxation for capital gains arising upon transfer of shares (acquired on or after 1 April 2017).

Singapore or Mauritius

Although Singapore is no longer a relevant jurisdiction for investors seeking to take advantage of tax arbitrage, Singapore is taking various steps to attract foreign investors, including by introducing the concept of a Singapore variable capital company (SVCC) to be used as a vehicle for investment. The SVCC is expected to simplify the process of redemption of open-ended funds. Currently, the redemption of open-ended funds is a long, drawn-out process involving drawing up of accounts, audit and issuance of a solvency certificate. Singapore also enjoys an edge over Mauritius because of its outstanding banking facilities, access to financial products and better talent, thus causing a shift of funds from Mauritius to Singapore.

vii Investment route for offshore funds

Foreign direct investment route

Investors typically route their investments in an Indian portfolio company through a foreign direct investment (FDI) vehicle if the strategy is to play an active part in the business of the company. FDI investments are made by way of subscription or purchase of securities, subject to compliance with the pricing guidelines, sectoral caps and certain industry-specific conditions. Such investments are governed by the rules and regulations set out under the FDI consolidated policy (the FDI Policy), which is issued every year by the DPIIT of the Ministry of Commerce and Industry, and the Foreign Exchange Management (Non-Debt Instruments) Rules 2019 (the NDI Rules). The NDI Rules supersede the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations 2017. While the changes introduced in the NDI Rules were originally not substantial, many changes have been pushed through individual amendments since its notification. Under the NDI Rules, in line with the erstwhile regulations, any investment of 10 per cent or more of the post-issue paid-up equity capital on a fully diluted basis of a listed company will be reclassified as an FDI. In addition, the NDI Rules stipulate that the pricing of convertible equity instruments is to be determined upfront and the price at the time of conversion should not be lower than the fair value at the time of issue of such instruments.

The NDI Rules have been aligned with the SEBI (Foreign Portfolio Investors) Regulations 2019 (the FPI Regulations) to provide that an FPI may purchase or sell equity instruments of an Indian company that is listed or to be listed subject to the individual limit of 10 per cent (for each FPI or an investor group) of the total paid-up equity capital on a fully diluted basis or the paid-up value of each series of debentures, preference shares or share warrants issued by an Indian company. The aggregate holdings of all FPIs put together (including any other permitted direct and indirect foreign investments in the Indian company) are subject to a cap of 24 per cent of the paid-up equity capital on a fully diluted basis or the paid-up value of each series of debentures, preference shares or share warrants. Such aggregate limit of 24 per cent can be increased by the concerned Indian company to up to the sectoral cap or statutory ceiling (as applicable) by way of a board resolution and a shareholders' resolution (passed by 75 per cent of the shareholders).

Previously, any investment in excess of the sectoral caps or not in compliance with the sectoral conditions required prior approval of the Foreign Investment Promotion Board (FIPB). In furtherance of its announcement in 2017, the government abolished the FIPB in

2017. In place of the FIPB, the government has introduced an online single-point interface for facilitating decisions that would previously have been taken by the FIPB. Upon receipt of an application for an FDI proposal, the administrative ministry or department concerned will process the application in accordance with a standard operating procedure (SOP) to be followed by investors and various government departments to approve foreign investment proposals. As a part of its initiative to ease business further, the SOP also sets out a time limit of four to six weeks within which different government departments are required to respond to a proposal. More than three years on, there is very little information in the public domain about the proposals processed by the SOP.

FPI route

Foreign investors who have a short investment horizon and are not keen on engaging in the day-to-day operations of the target may opt for this route after prior registration with a designated depository participant (DDP) as an FPI under the FPI Regulations. The FPI Regulations supersede the erstwhile SEBI (Foreign Portfolio Investors) Regulations 2014 (the 2014 Regulations). The process of registration is fairly simple and ordinarily it does not take more than 30 days to obtain the certificate.

In 2014, to rationalise different routes for foreign portfolio investments and create a unified and single-window framework for foreign institutional investors, qualified institutional investors and sub-accounts, SEBI, the security watchdog, introduced the regulations on FPIs. In December 2017, SEBI, with the intention of providing ease of access to FPIs, approved certain changes to the FPI Regulations, which included: (1) rationalisation of fit-and-proper criteria for FPIs; (2) simplification of the broad-based requirement for FPIs; (3) discontinuation of requirements for seeking prior approval from SEBI in the event of a change of local custodian or FPI DDP; and (4) permitting reliance on due diligence carried out by the erstwhile DDP at the time of the change of custodian or FPI DDP. In addition, with a view to improve ease of doing business in India, a common application form has been introduced for registration, the opening of a demat account and the issue of a permanent account number for the FPIs.

In 2019, SEBI introduced the FPI Regulations, with certain important changes from the 2014 Regulations, including:

a the re-categorisation of FPIs into two FPI categories (rather than the three FPI categories under the 2014 Regulations);

b for investment in securities in India by offshore funds floated by an asset management company that has received a no-objection certificate under the SEBI (Mutual Funds) Regulations 1996, registration as an FPI will have to be obtained within 180 days of the date of the FPI Regulations;

c the broad-based requirement (where the fund was required to be established by at least 20 investors) for certain categories of FPIs has been done away with;

d the concept of opaque structure has now been removed from the FPI Regulations such that the entities that are incorporated as protected cell companies, segregated cell companies or equivalent structures, for ring-fencing of assets and liabilities, can now seek registration as FPIs under the FPI Regulations. Having said that, under the 2014 Regulations, where the identity of the ultimate beneficial owner was accessible, such entities could fall outside the scope of opaque structures and, hence, obtain registration as an FPI. Similarly, while the concept of opaque structures has been removed under the FPI Regulations, FPIs need to mandatorily comply with the requirement of disclosure of beneficial owners to the SEBI; and

e the total investment by a single FPI, including its investor group, must be below 10 per cent of a company's paid-up equity capital on a fully diluted basis. If this threshold is exceeded, the FPI needs to divest the excess holding within five trading days of the date of settlement of trades resulting in the breach. The window of five trading days allows FPIs to avoid any change in the nature of their investments. However, upon failure to divest the excess holding, the entire investment in the company by the FPI (including its investor group) will be treated as an FDI, and the FPI (including its investor group) will be restricted from making further portfolio investments in terms of the FPI Regulations.

The clubbing of investment limits for FPIs is done on the basis of common ownership of more than 50 per cent or on common control. As regards the common-control criteria, clubbing shall not be done for FPIs that are: (1) appropriately regulated public retail funds; (2) public retail funds that are majority owned by appropriately regulated public retail funds on a look-through basis; or (3) public retail funds whose investment managers are appropriately regulated. The term 'control' is understood to include the right to appoint a majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of shareholding or management rights, by shareholders' or voting agreements, or in any other manner.

Under the original FPI regime, Category I FPIs were restricted to those who were residents of a country whose securities market regulator was either a signatory to the International Organization of Securities Commission's Multilateral Memorandum or had a bilateral memorandum of understanding with SEBI. Hence, Category I FPIs were essentially governments and related entities or multilateral agencies and were perceived to be the highest-quality and lowest-risk investors.

Pursuant to the reclassification of FPIs, the entities that have been added to Category I, inter alia, are: (1) pension funds and university funds; (2) appropriately regulated entities, such as insurance or reinsurance entities, banks, asset management companies, investment managers, investment advisers, portfolio managers, broker dealers and swap dealers; (3) appropriately regulated funds from Financial Action Task Force member countries; (4) unregulated funds whose investment manager is appropriately regulated and registered as a Category I FPI; and (5) university-related endowments of universities that have been in existence for more than five years. In addition, the Category II FPI includes all the investors not eligible under Category I, such as individuals, appropriately regulated funds not eligible as Category I FPIs and unregulated funds in the form of limited partnerships and trusts. An applicant incorporated or established in an international financial services centre (IFSC) is deemed to be appropriately regulated under the FPI Regulations.

Foreign venture capital investor route

The foreign venture capital investor (FVCI) route was introduced with the objective of allowing foreign investors to make investments in VC undertakings. Investment by such entities into listed Indian companies is also permitted subject to certain limits or conditions. Investment through the FVCI route requires prior registration with SEBI under SEBI (Foreign Venture Capital Investors) Regulations 2000 (the FVCI Regulations). Investment companies, investment trusts, investment partnerships, pension funds, mutual funds, endowment funds, university funds, charitable institutions, asset management companies, investment managers and other entities incorporated outside India are eligible for registration as FVCIs. One of the primary benefits of investing through the FVCI route is that FVCI investments are not subject to the RBI's pricing regulations or the lock-in period prescribed by the SEBI (Issue of Capital and Disclosure Requirements) Regulations 2018.

Pursuant to the FVCI Regulations, FVCIs must register with SEBI before making investments. The process typically takes 20 to 30 days from the date of application. To promote job creation and innovation, the RBI allowed for 100 per cent FVCI investment in start-ups. In this regard, the NDI Rules also allow FVCIs to purchase equity, equity-linked instruments or debt instruments issued by an Indian start-up, irrespective of the sector in which it is engaged, subject to compliance with the sector-specific conditions (as applicable). Previously, only investment in the following sectors did not require prior approval of the securities regulator:

a biotechnology;
b information technology;
c nanotechnology;
d seed research and development;
e pharmaceuticals (specifically in terms of discovery of new chemical entities);
f dairy;
g poultry;
h biofuel production;
i hotels and convention centres with a seating capacity of over 3,000; and
j infrastructure.

III THE INSOLVENCY CODE

2020 has been an unusual year for the Insolvency and Bankruptcy Code 2016 (IBC). Until February 2020, India witnessed 3,600 admitted cases relating to insolvency resolution out of which 205 were resolved and 89 have ended with liquidation. However, the number of admitted cases sharply dropped in 2020 as the government has suspended the insolvency proceedings against defaulting companies (i.e., companies who are unable to meet their payment obligations towards their creditors). This moratorium was put in place on account of the global pandemic and will be in continuation until March 2021.[42]

In 2020, as mentioned earlier, the most important amendments came through an ordinance to provide relief to pandemic-stressed companies by incorporating new provisions in the IBC that disallowed filing of applications for initiation of corporate insolvency resolution process. In addition, the appellate form, the National Company Law Appellate Tribunal has issued suo moto orders granting exclusion of lockdown period from the period of completion of corporate insolvency resolution process. Further, pursuant to a notification issued by the Ministry of Corporate Affairs (MCA) in March 2020, the threshold for minimum amount of default was increased from 100,000 rupees to 10 million rupees.

42 www.businesstoday.in/current/economy-politics/insolvency-and-bankruptcy-code-suspension-to-remain-in-force-till-march-31-2021/story/425605.html.

The immediate impact of the Insolvency Code is evident from the improvement in India's ranking in World Bank's 'resolving insolvency index', moving up to 52nd position in 2020 from 108th position in 2019.[43]

IV SOLICITATION, DISCLOSURE REQUIREMENTS AND FIDUCIARY DUTIES

Typically, investment vehicles issue a private placement memorandum (PPM) or an offer document to raise funds from prospective investors. The PPM sets out all material information to enable the investors to make an informed decision, including fund structure, summary of key terms, background of the key investment team, risk factors, disciplinary history and risk management tools in Category III AIFs.

In accordance with the AIF Regulations, managers and sponsors are beginning to set out the risk of their investments in relation to the minimum amount required to be invested. Because a PPM in India acts as both a marketing and a disclosure document, careful attention has to be paid while drafting the PPM to ensure a fine balance between regulatory requirements prescribed by SEBI and the marketing leverage that they want from their commitments to the fund.

With respect to offshore India-focused funds, the disclosure requirements, marketing guidelines and limits on solicitation are governed by the laws of the fund's domicile or jurisdiction. While there is no regulatory framework governing the marketing documents of offshore India-focused funds, under the AIF Regulations, AIFs are required to disclose certain financial information, including sharing valuation reports and filing the PPM with SEBI, for domestic funds. Further, there are limitations on the number of investors that an investment vehicle can attract. For instance, no AIF scheme (other than an angel fund) can have more than 1,000 investors.

Recognised as fiduciaries, directors of an investment vehicle are exposed to liabilities arising out of breach of their duties towards the fund and its stakeholders. Accordingly, directors should be mindful of their duties and exercise a supervisory role, during the entire cycle of a fund. For instance, at the time of fund formation, a director should ensure that the structure of the fund is tax-compliant, and that the information set out in the offer documents is not untrue or misleading. During the life of the fund, the directors should ensure policies regarding conflicts of interest are in place and adhered to. Similar principles are built into the AIF Regulations and the REIT Regulations, which require the sponsor and the manager to act in a fiduciary capacity towards their investors and disclose any potential conflicts of interest.

V TAXATION

i Taxation of foreign funds

Following the adoption of the GAAR on 1 April 2017, the Indian tax authorities have the ability to treat arrangements outside India as an 'impermissible avoidance arrangement' if the main purpose of the arrangement is to obtain a tax benefit and the arrangement has no

43 www.businesstoday.in/current/corporate/how-path-breaking-verdicts-crucial-amendments-shaped-insolvency-laws-in-2019/story/392738.html.

'commercial substance'. Mere location of the entity in a tax-efficient jurisdiction will not invoke the GAAR. Accordingly, it is critical for a fund to demonstrate commercial reasons for setting up a fund in a particular jurisdiction. The steps that a fund may undertake to demonstrate commercial reasons include the renting of office space, and employment of personnel in that jurisdiction.

The other potential taxation risk in India for offshore funds is the risk of being perceived to have a permanent establishment in India on account of the fund's relationship with the investment advisory team based in India, in which case it would be liable to tax in India. As stated earlier, when determining POEM and actual residency status of an entity, the key guiding principle is, inter alia, to demonstrate that decision-making for the fund is being undertaken at the offshore fund level and not in India. To encourage fund management in India, the Finance Act 2015 provided for safe-harbour rules, where fund management activity carried out through an eligible fund manager in India by an eligible investment fund shall not constitute a business connection in India, subject to the fund and fund manager satisfying various restrictions, such as participation or investment by persons resident in India to be limited to 5 per cent, and a prohibition on the fund making any investment in its associate entity and carrying on or controlling and managing any business in India or from India.

ii Taxation of domestic funds

Category I and Category II AIFs enjoy a tax pass-through status. Accordingly, the income from investment is not taxed in the hands of such funds but is taxed in the hands of the unitholders. The taxation of Category III AIFs depends on the legal status of the fund (i.e., company, limited liability partnership or trust). Accordingly, investment fund income, other than the business income, is exempt from tax and income received by or accrued to Category I and Category II AIF unitholders is chargeable to tax in the same nature and in the same proportion as if it were income received by or accrued to the unitholder had the investment been made directly by the unitholder. This amendment has provided long-awaited clarity to AIFs given that, prior to this amendment, AIFs were subject to trust taxation provisions that posed several tax uncertainties.

On similar lines, amendments were made to provide pass-through status to REITs and InvITs. Taxes are imposed on these in the manner set out below.

Particulars	SPVs	REITs	Sponsor/investor
Dividend	Exempt subject to conditions	Exempt	Exempt
Interest	No withholding	Exempt	Taxable
Rental income (only applicable for REITs, not InvITs)	No withholding	Exempt	Taxable
Capital gains	N/A	Taxable	Exempt
Other income	N/A	Taxable	Exempt

Further, tax implications for different streams of income in the hands of the investors are set out below.

Dividends

Hitherto, dividends declared by Indian companies attracted a dividend distribution tax at the effective rate of 20.56 per cent, with the dividends being tax exempt in the hands of shareholders. Considering the excessive tax liability on undistributed or distributed profits of a domestic company as well as on the investors, the government has, *vide* Finance Act 2020, abolished dividend distribution tax and adopted the classical system of dividend taxation. Now, dividend will be taxable in the hands of investors at the rates applicable to them under the relevant DTA. Non-resident investors will also be able to claim foreign tax credit of such withholding tax in their resident country, which otherwise may not have available to them in the erstwhile regime.

Interest

Interest income is subject to tax in the hands of Indian resident investors at the rate that would otherwise apply to the investors on their ordinary income. Income from interest on debt ranges from 5.4 per cent to 43.68 per cent, depending on the regulatory regime, currency of debt and rate of interest.

Capital gains

Any short-term capital gain arising on the transfer of listed equity shares on any recognised stock exchange in India, where securities transaction tax is payable, is subject to tax at the rate of 15 per cent (plus applicable surcharge and cess) subject to any tax benefit under the relevant tax treaty. Sales off the market that result in short-term gain are subject to tax at the rate of 40 per cent (plus applicable surcharge and cess) in case of a foreign company, and 30 per cent (plus applicable surcharge and cess), subject to any tax benefit under the relevant DTA, and at the applicable marginal rate in the case of residents.

Any long-term gain on sale of listed securities is taxed at 10 per cent (plus surcharge and cess) in case of a resident and a non-resident. Further, any long-term gains on sale of unlisted securities are taxed at 10 per cent (plus surcharge and cess) in the hands of the non-resident and at 20 per cent (plus surcharge and cess) in the hands of resident (without the benefits of indexation and neutralisation of foreign exchange fluctuation).

Losses

With effect from 1 April 2020, any accumulated losses (in the nature of business loss) incurred by Category I or Category II AIFs will be passed to the investors who will be able to set these off against their income, provided that they have held units in the AIF for longer than 12 months. In addition, with effect from 1 April 2020, any accumulated losses (not in the nature of business losses) incurred by Category I or Category II AIFs prior to 31 March 2019 will be passed to the investors, subject to the condition that they held units in the AIF on 31 March 2019. Accordingly, such losses can be carried forward and set off by the investors against their income from the year in which the loss had first occurred, taking that year as the first year in accordance with Chapter VI of the Income Tax Act. However, such pass-through benefit of losses will not be available to investors who acquired units of AIFs on or after 1 April 2019.

Offshore investments

By way of a circular dated 3 July 2019, the Central Board of Direct Taxes has clarified that any income in the hands of a non-resident investor from offshore investments routed through a Category I or Category II AIF that is deemed a direct investment outside India is not taxable in India under Section 5(2) of the Income Tax Act. The circular further clarified that any exempt loss arising from the offshore investment by a non-resident investor may not be set off or carried forward against the income of the Category I or Category II AIF. This clarification essentially prevents double taxation of the non-resident investor's income in India and in its country of residence.

IFSC

The Finance Act 2019 exempted taxation of income arising from the transfer of global depository receipts, rupee-denominated bonds and derivatives on a stock exchange in an IFSC, for non-resident investors of Category III AIFs, provided that the income is solely in the form of convertible foreign exchange and all units of the AIFs are held by non-residents (except for units held by the sponsor or manager). The scope of this exemption has been further expanded vide the Taxation and Other Laws (Relaxation and Amendment of Certain Provisions) Act, 2020 by extending it to (1) income on transfer of any securities (other than shares in a company resident in India); (2) income from securities issued by a non-resident where such income otherwise does not accrue or arise in India; and (3) business income from a securitisation trust. This exemption is a positive step to boost offshore funding raising by Category III AIFs in an IFSC.

Additionally, a unit situated in an IFSC (as defined under the Special Economic Zones Act 2005) is exempt from tax on dividend distributed from income accumulated by such unit from its operations in the IFSC from 1 April 2017. Similarly, the distributions made by mutual funds located in IFSCs, which derive income solely in the form of convertible foreign exchange and all units of which are being held by non-residents, are tax exempt.

VI REGULATORY DEVELOPMENTS

i Amendments to Foreign Direct Investment Policy

Under the foreign direct investment policy (the FDI Policy), any investment by a citizen or an entity of or incorporated in Bangladesh or Pakistan required prior government approval. Additionally, investments from Pakistan were prohibited in sectors such as defence, space and atomic energy. In this regard, a significant amendment to India's FDI policy came in April 2020 through Press Note 3 of 2020 (Press Note 3) issued by the Department of Industrial Policy and Promotion, Government of India, which imposed certain restrictions on investment in India by entities residing in countries sharing a land-border with India. Press Note 3 was issued with the intent of curbing opportunistic takeovers and acquisitions of Indian companies at distressed valuations, in light of the disruptions caused by the covid-19 pandemic. Pursuant to Press Note 3, any investment by an entity of a country that shares a land border with India or where the beneficial owner of an investment into India is situated in or is a citizen of any such country will require the prior written approval of the government of India. Accordingly, any potential investor into India will need to test their shareholding structure to confirm whether there is any beneficial ownership by an entity or individual with citizenship to whom such location restrictions apply.

In addition, Press Note 3 does not define the term 'beneficial ownership'. Accordingly, stakeholders have relied on the definition of beneficial ownership as defined in other legislations such as Companies (Significant Beneficial Owners) Rules, 2018 or the Prevention of Money-Laundering (Maintenance of Records) Rules, 2005. However, these legislations prescribe different thresholds for determination of beneficial owners, adding to the regulatory uncertainty.[44] In addition, Press Note 3 has introduced the requirement of prior approval of the government of India in case of transfer of any current or future foreign direct investment in any Indian entity that results in the beneficial ownership being transferred to any person of a country sharing its land borders with India.

Another important amendment to the FDI policy was introduced in February 2020 pursuant to which foreign investors are now permitted to acquire up to a 100 per cent stake in an insurance intermediary, subject to verification by the Insurance Regulatory and Development Authority of India. Accordingly, investments in intermediaries such as insurance brokers, insurance consultants, surveyors and third-party administrators can be made under the automatic route.

ii Relaxations under the IBC

As set out in Section III, the government has provided certain exemptions and relaxations through certain amendments to the IBC, one of the most significant being the prohibition on filing of applications for corporate insolvency resolution (against entities that have defaulted in payments to their creditors) after 25 March 2020. This relaxation was initially valid for a period of six months but has now been extended until 31 March 2021. In addition, the resolution professional (appointed for, inter alia, overseeing the insolvency resolution process) has been precluded from initiating proceedings against directors of corporate debtors accused of fraudulent or wrongful trading, for instances where the filing of applications for initiation of corporate insolvency resolution process have been disallowed. Another notable development is the increase in the minimum amount of default from 100,000 rupees to 10 million rupees. Consequently, the number of admitted cases have reduced significantly, which has provided much need relief to companies dealing with the onslaught of the covid-19 pandemic.

iii REITs and InvITs

In January 2020, SEBI issued guidelines on rights issue of units by InvITs and REITs, which were subsequently amended in March 2020. These guidelines provide a framework for issue of units by a listed InvIT or REIT to its unitholders, prescribing certain conditions such as minimum subscription of 90 per cent, pricing and provision for fast-track rights issue. This will ensure that the REITs are able to raise funds while at the same time meeting certain regulatory thresholds.

In June 2020, SEBI amended the REIT Regulations and the Infrastructure Regulation with a view towards enhancing the ease of doing business in India. One of the key amendments permitted sponsors of InvITs and REITs, whose units have been listed for a period of three years to de-classify themselves (i.e., cease to be a sponsor), subject to the approval of the

44 The Companies (Significant Beneficial Owners) Rules, 2018 prescribe a threshold of 10 per cent for significant beneficial owner of a company while the Prevention of Money-Laundering (Maintenance of Records) Rules, 2005 prescribe 25 per cent controlling ownership or profit share of the company or person who holds the position of senior managing official, for identifying the beneficial owner.

unitholders of the relevant InvITs and REITs. This amendment will effectively allow the persons identified as sponsors to step down from such position subject to fulfilment of certain conditions.

Another key change relates to change or change of control of the sponsor or the inducted sponsor of an InvIT or REIT, which now requires approval of 75 per cent of the unitholders of the relevant REIT/InvIT (by value) excluding the value of units held by parties related to the transaction. In the event such approval is not obtained, the inducted sponsor or sponsor needs to provide an exit to the dissenting unitholders by purchasing their units. In addition, the term 'change in sponsor' has been defined to mean any change because of the entry of a new sponsor, whether or not the existing sponsor has exited. This amendment effectively grants additional protections in relation to the rights of unitholders of just investment trusts.

In this context, prior to June 2020, each sponsor under the REIT Regulations needed to hold at least 5 per cent of the outstanding units of a REIT at any time. In addition, the sponsor and its sponsor group were required to hold at least 15 per cent of the outstanding units of the REIT. The amendments to the REIT Regulations in 2020 have done away with the perpetual lock-in of sponsor and sponsor-group's unitholding. Currently, the REIT Regulations mandate a post-listing lock-in of 25 per cent of the outstanding capital of REIT for a period of three years. Moreover, a lock-in period of one year will apply in the event the unitholding exceeds 25 per cent in the REIT.

iv Amendments to AIF Regulations

In October 2020, SEBI amended the requirements to be fulfilled by the key investment team of the 'manager' of an AIF. Under the new norms, the key investment team of the manager of an AIF should have minimum experience of five years and adequate professional qualification. These requirements may be fulfilled individually or collectively by the personnel of key investment team.

In addition, a new provision was added to the AIF Regulations which provides that the manager of the AIF will be responsible for all the investment decisions of the AIF. In this context, the manager may constitute an investment committee subject to compliance with certain conditions, including the following: (1) members of the committee will be equally responsible for the investment decisions as the manager; (2) the manager and the investment committee will jointly and severally ensure compliance of the investments with the AIF Regulations, any fund documents or any agreement with the investors; and (3) external members whose names were not disclosed in the placement memorandum may be appointed only with the consent of 75 per cent of the investors (by value of their investment in the AIF). Such provisions have been introduced for ensuring the competency of the key investment teams of AIF managers.

v Amendments in the consequences of certain offences under the Companies Act, 2013

In order to ensure ease of compliance, the MCA has modified the consequences of certain offences under the Companies Act, 2013 (CA 2013) and deleted the penal provisions for other offences. The recent amendments introduced in September 2020, inter alia, provided for a reduction in the amount of monetary penalty for certain offences (such as failure to filing notices for alteration of share capital, filing of annual return, filing of board or shareholders' resolutions and surpassing the prescribed maximum number of directorships).

In addition, the several existing offences have been de-criminalised by removing the penalty of imprisonment in relation to, inter alia, offences pertaining to buy-back of securities, mis-statements in financial statements and board's report, improper constitution of sub-committees and failure of directors to disclose interest in matters in which he or she is interested. Moreover, the amendments also re-categorised certain offences from compoundable offences to in-house adjudication framework. Accordingly, various registrars of companies can now adjudicate on such offences, thus reducing the burden of the National Company Law Tribunal.

In addition to the aforesaid changes introduced for the purpose of easing the compliance requirements of companies doing business in India, CA 2013 has been appropriately amended to deal with the exigencies of the covid-19 pandemic. Earlier, certain matters (such as approval of annual financial statements, board report and prospectus) could not be dealt with in a board meeting through video conferencing or any other audio-visual means. In other words, decisions on such matters required the physical presence of the requisite quorum of directors. This condition has been relaxed in March 2020 and will continue until June 2021. Accordingly, all corporate matters can now be dealt with in a board meeting through video conferencing or any other audio-visual means, without any restriction. In respect of general meetings of shareholders of a company, the MCA has issued several circulars and directions in 2020 that have set down the norms to be followed for conducting such meetings through video conferencing or other audio-visual means until 31 December 2021.

vi Filing of resolutions by non-banking financial institutions

Under CA 2013, banking companies were exempted from filing of resolutions passed by their board of directors for grant of loans, guarantees or providing security in respect of loans, in the ordinary course of their business. Pursuant to the amendments to CA 2013 in September 2020, such exemption has now been extended to all classes of non-banking financial companies and housing finance companies. This exemption will reduce the day-to-day procedural burden on the non-banking financial companies and housing finance companies that perform activities similar to those of banking companies.

vii Relaxations for conducting board and general meetings of companies

As per the Companies (Meetings of Board and its Powers) Rules, 2014, certain matters (such as approval of annual financial statements, board report, prospectus, etc.) cannot be dealt with in a board meeting through video conferencing or any other audio-visual means, except where the quorum requirement is satisfied by the directors physically present. This condition has been relaxed through amendment to the relevant rule in March 2020, in light of the restrictions posed by the global pandemic, and shall continue until June 2021. Accordingly, all matters can now be dealt with in a board meeting through video conferencing or any other audio-visual means without any restriction.

In respect of general meetings, the MCA has issued several circulars and directions in 2020 to ease certain norms: (1) extension of the due date for conducting the annual general meeting until 31 December 2020; and (2) permitting conducting of extra-ordinary general meetings as well as annual general meetings through video conferencing or other audio-visual means until 31 December 2021, subject to compliance of the procedural requirements specified in the relevant circulars.

viii Developments relating to compromise or arrangement

The central government in February 2020 notified Sections 230(11) and 230(12) of CA, which deal with takeover offers in unlisted companies. The section provides for arrangements between a company and its creditors or members or any class of them, specifying the procedure to be followed to make such a compromise or arrangement.

The newly notified Section 230(11) provides that in the case of unlisted companies, any compromise or arrangement may include a takeover offer. Section 230(12) permits a party aggrieved by the takeover offer to make an application, bringing its grievance before the National Company Law Tribunal (NCLT). In addition, the MCA has also notified the corresponding rules that prescribe the manner in which applications may be made under the aforesaid sections.

In effect, these provisions allow majority shareholders, holding 75 per cent of the shares of a company, to make a takeover offer to acquire any part of the remaining shares, by way of an application before the NCLT. For this purpose, shares have been defined to mean equity shares or securities such as depository receipts, which entitle the holder thereof to exercise voting rights. In addition, the amended rules set out the manner in which a minority shareholder (or any other party) aggrieved by such offer may make an application to the NCLT in relation to his or her grievances.

VII OUTLOOK

Despite the Indian economy facing a slowdown, PE/VC investment levels in India continued to maintain parity with that of 2019, albeit largely as a result of the funding secured by the Reliance group for its technology and retailing arms, from a slew of foreign investors. However, excluding the Reliance deals, the Indian PE-VC ecosystem witnessed an aggregate investment of US$37.33 billion, which is a far cry from US$47.3 billion. Moreover, exits by PE/VC firms in 2020 suffered a sharp decline because of declining valuations, reaching a six-year low. However, the capital markets in India have been exuberant and there is an expectation of a number of PE portfolio company driven listings in the first half of 2021.

As we progress into 2021 with the worst of the global pandemic behind us, India is likely to be one of the fastest growing major economies over the next decade, which makes it an extremely attractive market for the global private equity industry. PE investments are expected to grow by 15 to 25 per cent as a result of India's growth potential owing to government initiatives and enhancements in ease of doing business, as well as an above-average showing in results by the Indian industry over 2020.

Chapter 8

ITALY

Enzo Schiavello and Marco Graziani[1]

I GENERAL OVERVIEW

Italian fundraising figures have varied significantly in recent years. Commitments raised by independent fund managers amounted to €2.487 billion in 2015, dropped to €1.313 billion in 2016, reached a €6.239 billion peak in 2017 and then dropped again to €3.415 billion in 2018.[2] New commitments totalled only €410 million in the first half of 2019, with a reduction of 75 per cent compared with the first half of 2018.[3] Of the total 2018 commitments, private fund managers raised €2.738 billion compared to €920 million in 2017.[4] Of the 2018 commitments raised by private fund managers, 36 per cent was made by international investors, which fell to 27 per cent in the first half of 2019. Pensions funds and other retirement schemes were the larger investors, accounting for an overall 24 per cent of the total commitments in 2018 (17.7 per cent in the first half of 2019). Family offices and individual investors were the second larger investors, however, with commitment reducing from 27 per cent in 2017 to 15.4 per cent in 2018 (17.6 per cent in the first half of 2019). There were 34 firms engaged in raising funds in 2018 (only 14 in the first half of 2019).

Private equity (PE) and venture capital funds raising money in 2018 and 2019 included F2I's third fund (infrastructure – €3.6 billion at final closing in 2018);[5] Ambienta III (€635 million at final closing in 2018); Alto Capital IV (€210 million at final closing in 2018); Green Arrow Capital's Private Equity 3 (€230.6 million at final closing in 2018); Programma 102 (€65 million at first closing in 2018); Italia Venture II – Fondo Imprese Sud (€150 million at first closing in 2018); B4 H II – Fondo EuVeca (€43 million at first closing in 2018); UV2 (€120 million at final closing announced in 2019); FII Tech Growth (€110 at second closing in 2019); FoF PE Italia (€200 million at first closing in 2019); Fondo Agroalimentare Italiano (€55 million at final closing in 2019); Wise Equity V(€260 million at final closing); IGI Investimenti Sei (€140 million at second closing in 2019); FSI Mid-Market Growth Equity Fund (€1.4 billion at final closing in 2019); Progressio Investimenti III (€250 million at final closing in 2019); Italian Strategy (€50 million at first closing in 2019); Gradiente II (€135 million at final closing in 2019); and Private Equity Arcadia Small

1 Enzo Schiavello and Marco Graziani are partners at Legance – Avvocati Associati. The information in this chapter was accurate as at March 2020.

2 The figures in this chapter (other than those relating to individual funds) are published by AIFI, the Italian Private Equity, Venture Capital and Private Debt Association.

3 The figures for the second half of 2018 were not available at the time of writing.

4 The remaining commitments were raised by institutional fund managers sponsored by Cassa depositi e prestiti. This information is not available for the first half of 2019.

5 Including a €1.74 billion rollover of commitments from F2I's first fund (merged into the third fund).

Cap II (€80 million at final closing in 2019). With some exceptions reflecting the current market tendency towards larger commitments concentrated on fewer managers, fundraising periods are generally becoming longer. While public data is not available (and sponsors' statements about the launch of a fund sometimes do not consider the start date to be the time when fundraising efforts actually commenced), it is not uncommon for a fund to take more than a year to achieve the first closing. Fund terms proposed to investors may include a right of the manager to extend the maximum delay between first and final closing beyond the customary 12 months (generally up to an additional six months) subject to investor consent.

Apart from the perception of the country's political instability limiting the appetite of large international investors for local funds, other structural factors influence the Italian fundraising landscape, which is not catching up with the significant increase in global fundraising numbers in recent years. Allocations to private equity by Italian pension funds continue to represent a very limited portion of their assets compared to pension funds in other Western countries. Also, pension funds are now more willing than in the past to diversify their PE commitments geographically, and this is reducing allocations to local funds.[6] This situation is unlikely to change rapidly. While Italian managers receive limited support from domestic institutional investors, only some of them have the size, track record and ability to raise funds in the international markets. Another element to note is that sub-threshold managers under Directive 2011/61/EU on Alternative Investment Fund Managers (AIFMD) are subject to an authorisation requirement pursuant to Italian law. This is making the market for venture capital and other small funds less dynamic and diversified than it was in the pre-AIFMD scenario (when unregulated structures were also available).

Notwithstanding the above, the private equity industry appears to have significant potential for further growth, given the size and dynamism of the Italian economy, the large number of small and medium-sized enterprises (SMEs) that need to optimise their funding sources (still dominated by the banking system) and capture opportunities for export growth, and the new generations of fund managers progressively changing the face of the industry. Tax incentives have been introduced in recent years to foster direct and indirect long-term investment in local SMEs by pension funds.

II LEGAL FRAMEWORK FOR FUNDRAISING

i Preferred jurisdictions and legal forms

Italian sponsors typically establish private equity funds as contractual structures governed by Italian law and managed by investment entities authorised and supervised by the Bank of Italy. Establishing funds under the law of another jurisdiction is infrequent for Italian sponsors. In some instances, funds were formed as English limited partnerships considering their particular investor base or the management team's ability to implement an investment strategy covering multiple jurisdictions.

The transposition of the AIFMD into law did not significantly alter the regulatory framework that was applicable to private equity and other alternative funds beforehand. Collective portfolio management was already a regulated activity requiring prior authorisation, and the conditions to meet for the release of the authorisation were substantially similar to those

6 For example, Cassa Forense (lawyers' pension fund) committed €175 million, as anchor investor, to Asset Management Umbrella Fund, an initiative promoted by the European Investment Fund to offer diversified exposure to funds investing in EU small and medium-sized enterprises.

applying under the AIFMD. This framework applied to both open-end harmonised funds under EU directives (UCITS) and other funds, including private equity funds (alternative investment funds (AIFs)). However, the definition of collective portfolio management was narrow before the implementation of the AIFMD as it only covered contractual funds and SICAVs, so non-UCITS funds could be established also as unregulated structures. Over time, this gave birth to a number of funds set up as corporate vehicles under ordinary company law.

Because the AIFMD applies to all AIF managers (AIFMs) irrespective of the legal nature of AIFs, this regulatory framework changed with the implementation of the AIFMD. AIFs may now be established in contractual or corporate form, both structures being regulated by law. Also, in implementing the AIFMD, Italy gold-plated its provisions regulating sub-threshold AIFMs[7] by requiring all AIF managers to be authorised (with limited regulatory differences between full-scope and sub-threshold managers).

The regulatory regime applicable to all AIFs requires the appointment of a depositary carrying out safekeeping and other functions in accordance with the AIFMD. Only Italian banks and investment firms (or local branches of EU banks and investment firms) can be authorised by the Bank of Italy to carry out depositary functions. An important distinction between AIFs is based on their permitted investors. If the governing rules of an AIF limit them to certain qualifying investors,[8] the AIF (a reserved AIF) is subject to a more flexible regulatory regime. In particular: (1) commitments to a reserved AIF may be drawn down on an as-needed basis; (2) its constitutive documents are not subject to the prior approval of the Bank of Italy; and (3) the Bank of Italy provisions on limitation and diversification of risk concerning the generality of AIFs do not apply. The governing documents of a reserved AIF must contain provisions setting out, among other things, its investment restrictions, the maximum level of leverage the AIF can employ and the types and sources of permitted leverage.

In this environment, private equity funds[9] are almost invariably set up as closed-end reserved AIFs of a contractual nature. While corporate structures (SICAFs) are also available as alternative legal vehicles, these structures are now subject to comparable regulatory requirements to contractual funds. Because their constitutive documents are more complex than those of contractual funds, corporate vehicles definitely lost appeal compared to the pre-AIFMD (unregulated) scenario. Funds covered by Regulation (EU) No. 345/2013 on European venture capital funds, as amended (the EuVECA Regulation)[10] can be established in Italy as closed-end reserved AIFs taking contractual or corporate form subject to the above considerations. The managers of European venture capital (EuVECA) funds qualify as AIFMs. As such, they are subject to an authorisation requirement[11] in the Italian regulatory system.

7 Under the AIFMD, a light registration regime applies to sub-threshold AIFMs but national authorities may impose stricter rules.

8 These include (1) professional investors under the AIFMD, (2) entities and individuals making a commitment of €500,000 or more to the AIF, and (3) directors and employees of the AIFM.

9 Private equity funds may not be established as open-end vehicles under Italian regulatory provisions.

10 See footnote 24.

11 Sub-threshold managers of EuVECA funds must be registered in a special roll kept by the Bank of Italy. To obtain this registration, the managers must satisfy conditions mirroring those applicable to sub-threshold AIFMs requesting an authorisation.

Main legal and regulatory provisions

The following are the principal Italian laws and regulations applicable to reserved AIFs and their managers:

a Legislative Decree No. 58 of 24 February 1998, as amended, is the main piece of legislation regulating financial markets and intermediaries;

b Ministry of Economy and Finance Decree No. 30 of 5 March 2015 regulating the structure of AIFs and other general criteria to be met by them;

c Regulation of the Bank of Italy dated 19 January 2015, as amended, regulating the management of AIFs (including provisions governing the authorisation process and requirements applicable to managers, subsequent ongoing regulatory requirements, supervision and prudential requirements);

d Regulation of the Bank of Italy dated 5 December 2019, setting out the corporate governance and organisational requirements to be met by, among others, AIFMs;

e Regulation No. 20307 of 15 February 2018 of the Italian Securities and Exchange Commission (Consob), setting out rules of conduct applicable to certain intermediaries, including AIFMs, with a view to protecting investor interests; and

f Consob Regulation No. 11971 of 14 May 1999, as amended, regulating issuers of securities and including provisions concerning the marketing of fund interests.

Contractual funds

Fund

A contractual fund is a pool of assets and liabilities created pursuant to a board decision of an authorised manager and segregated by operation of law from all other assets and liabilities of the manager (including those of other funds managed by it), the depositary and the investors. Under the legal segregation rules, the fund's assets are protected against possible claims and legal actions filed by the creditors of the manager, other funds managed by it, the depositary and the investors. The fund's creditors may only enforce their claims against the assets of the fund (i.e., not against those of the individual investors, or those of the manager, which is not liable for the fund's debts to third parties).

The governing rules of a fund and the subscription agreements signed by the investors (in a form prepared by the manager) are the fund's constitutive documents. The governing rules are approved by the manager when establishing the fund and are accepted by investors by signing their subscription agreements. By accepting the governing rules of a fund, an investor enters into a contractual relationship with the manager that is governed by Italian law. The governing rules of a reserved AIF do not require prior approval from the Bank of Italy; however, the rules must be delivered to the Bank after the AIF is established (reserved AIFs are regulated structures subject to the supervisory powers of the Bank of Italy). Managers can issue side letters to individual investors but any preferential treatment an investor obtains under a side letter or its subscription agreement must comply with fairness and disclosure principles provided for by the AIFMD. Also, side letters and subscription agreements may not contain terms conflicting with those of the fund's governing rules.

Manager

Contractual funds can be established and managed by Italian authorised managers (SGRs) or other full-scope EU AIFMs acting under AIFMD passport provisions.

SGRs are Italian companies authorised by the Bank of Italy to provide collective portfolio management services. An SGR qualifies as a sub-threshold manager if the volume of its total assets under management is below certain thresholds established by the AIFMD[12] and it has not opted into the full scope of the AIFMD. Sub-threshold SGRs benefit from more relaxed regulatory requirements than full-scope SGRs concerning own funds, remuneration policy, control functions, valuation of assets, outsourcing of manager functions to third parties and some other matters. Unlike full-scope SGRs, sub-threshold managers cannot rely on the AIFMD passport provisions. A company wishing to obtain authorisation as an SGR to manage private equity funds must satisfy a number of conditions, including the following: (1) company limited by shares (legal form); (2) registered office and headquarters in Italy; (3) initial share capital of €500,000 (for full-scope SGRs) or €50,000 (for sub-threshold SGRs); (4) directors, general managers and statutory auditors meeting certain moral, independence, experience, skills, fairness and other requirements; (5) owners of qualifying holdings meeting certain moral, skills and fairness requirements; and (6) group structure not preventing a sound and prudent management and the effective exercise of supervisory functions by the Bank of Italy and Consob. If all applicable legal and regulatory requirements are complied with and the conditions for a sound and prudent management are met, the Bank of Italy will release the authorisation. An authorisation process may take five months or more to complete. Documents to be enclosed with the application include a description of the internal organisation and the main aspects of the proposed policies and procedures of the applicant as well as a regulatory business plan. SGRs are subject to ongoing regulatory requirements concerning the operation of their business, their own funds, reporting duties to the Bank of Italy and Consob, etc.

At present, Italian funds managed by AIFMs of other EU jurisdictions acting under the AIFMD passport provisions represent a very limited portion of the total market. However, the number of EU AIFMs establishing Italian funds is growing as a consequence of tax considerations concerning the proper structuring of Italian investments made from other EU jurisdictions.

SICAFs

SICAFs were introduced in Italy as regulated entities with the implementation of the AIFMD. SICAFs can be formed as reserved AIFs and can be managed internally or by an external manager (an SGR or a full-scope EU AIFM). Unlike contractual funds, externally managed SICAFs cannot be formed unless their prospective founding shareholders obtain an authorisation from the Bank of Italy.[13] Internally managed SICAFs have the double nature of AIFs and managers. An authorisation of the Bank of Italy is required for their formation. This authorisation covers only their internal management (internally managed SICAFs cannot manage other AIFs).

When the AIFMD was transposed into law, all then existing corporate vehicles carrying out private equity or venture capital investments and falling within the definition of AIF were faced with the alternatives of applying for an authorisation as SICAFs or being liquidated.

12 €500 million if the assets are acquired without the use of leverage at fund level and the investors have no redemption rights exercisable during a period of five years following the date of initial investment in each AIF. €100 million in all other cases.

13 Indeed, these SICAFs can retain a number of functions that, in the event of a contractual fund, fall within the responsibilities of an authorised manager (including marketing of shares and valuation of assets).

Many of them opted to continue their investment business as SICAFs and applied for the authorisation. To our knowledge, only a few SICAFs were formed thereafter (mostly in the real estate sector). Contractual funds are indeed simpler legal vehicles, and adopting the corporate form provides no particular tax or other advantage.

ii Key legal terms

Traditionally, the terms of Italian funds targeting only domestic investors are simpler than those seeking commitments from international investors, although the gap is slowly closing and standard fund terms in the private equity arena are becoming the norm also for purely domestic funds.

The Italian regulatory framework has some impact on the terms of private equity funds. Investors may not be granted the right to opt out of specific investments. Italian law indeed provides that investors should share pro rata (in accordance with the rights attached to their class of fund interests) in the income, gains and losses of all portfolio investments of a fund. This makes negotiation on investment restrictions less flexible than it would be with fund vehicles in other jurisdictions as all restrictions should be contained in the fund's governing rules (not in side letters). Annual and semi-annual valuations of portfolio investments and fund interests must be made in compliance with (conservative) criteria laid down by the Bank of Italy. However, common fund terms require managers to provide investors with quarterly reports including valuations made in accordance with the International Private Equity and Venture Capital Valuation (IPEV) Guidelines issued by the IPEV Board.

Distribution waterfalls almost invariably follow the European 'fund-as-a-whole' model with an 8 per cent hurdle rate and a 20 per cent carried interest (with a catch-up mechanism). The greater bargaining power of investors after the financial crisis has resulted in tougher and more protracted negotiations putting certain traditional fund terms under pressure. Escrow and clawback provisions are more frequently negotiated to ensure effective protection against the risk of paying excess carry to the manager or members of its team. Given the small size of most local funds, average management fees continue to be 2 per cent of commitments during the investment period and 2 per cent of invested capital net of write-offs thereafter. However, rebates are frequently negotiated with investors making large commitments, particularly investors joining a fund at first closing. Extensions of a fund's investment period or term require the consent of a majority in interest of investors (less frequently of the advisory committee), and during such extensions investors normally expect to pay lower fees. The commitment a manager and its affiliates are typically requested to make to a fund is around 2 per cent of total commitments although individual arrangements may vary depending on a number of factors. No-fault remedies sought by investors often include, in addition to the removal of the manager, a right to trigger an early termination of the investment period or an early liquidation of the fund. However, these latter remedies tend to be pushed back by managers in exchange for other concessions. Key manager provisions attract much more attention than in the past, also as a consequence of some breakaways of senior team members of established fund managers in recent years. Triggers are generally becoming stricter and unresolved key manager events are often treated as cause for a removal of the manager (with limited exceptions depending on the nature of the event and with partially different economic implications). The definition of cause and the carve-outs in the exculpation and indemnification provisions have become other areas of more intense negotiation.

Side letters are commonly issued to address investor-specific needs or requests, including seats on the advisory committee, co-investment opportunities and particular information or assistance requirements. Most-favoured nation clauses are recurring provisions in side letters. As the governing rules of a fund prevail over conflicting terms contained in side letters, care should be taken in determining whether (or subject to what conditions) a particular matter can be dealt with through a side letter.

iii Key items for disclosure

Fundraising

Fund managers generally prepare a private placement memorandum (PPM) containing information in line with market practice for delivery to potential investors. A PPM typically includes information on the manager and its team, an overview of the relevant market, a description of the manager's investment strategy, deal flow, sourcing and investment process, the track record of the manager and senior team members, case studies from the manager's track record, a summary of key terms, a description of risk factors and a discussion of the main legal, regulatory and tax considerations affecting an investment in the fund. It is common practice for managers also to establish an electronic data room containing more detailed information on the manager and its investment transactions, legal documentation, updates and, frequently, responses to a standard due diligence questionnaire (DDQ) designed to streamline the due diligence process. PPMs and standard DDQs are very often prepared with the assistance of a placement agent.

Information contained in marketing documents must be accurate, comprehensible and non-misleading pursuant to applicable regulatory provisions. In addition, certain mandatory disclosures to potential investors are imposed by Italian and EU law. These include:

a pre-contractual information on the manager, its services, some of its policies, the nature of the fund interests and connected risks, all costs to be borne by investors in connection with an investment in the fund and the classification of investors as professional or retail clients under the provisions implementing the Markets in Financial Instruments Directive (MiFID);[14]

b an offering document concerning the fund containing the information set out in Article 23 of the AIFMD (the offering document); and

c if fund interests are offered to retail investors,[15] a short-form document containing key information on the fund in the format prescribed by Regulations (EU) Nos. 1286/2014 and 2017/653 (key information document (KID)).

Full-scope AIFMs must file the offering document under (b), above, with Consob and obtain a no-objection letter under the provisions implementing the AIFMD before fund interests can be marketed (see Section II.iv). If required, the KID is also to be submitted to Consob before marketing of fund interests (to retail investors) commences. The offering document and the KID must be kept separate from the PPM and other marketing documents.

14 See footnote 23.

15 Qualifying investors in reserved AIFs include retail investors committing €500,000 or more to the AIF.

Periodic reporting

For each managed fund, the manager must prepare and make available to investors the following documents in the format prescribed by applicable regulatory provisions:

a annual financial statements within six months of the end of any financial year (or of the shorter period in relation to which profits are distributed);

b semi-annual financial statements within two months of the end of any six-month calendar period; and

c a prospectus showing the value of the fund interests as at the end of any calendar semester.

Investments are valued in accordance with criteria set out by the Bank of Italy. The annual financial statements must be audited. Common fund terms generally impose shorter delivery terms for these documents and require managers to provide investors with quarterly reports prepared in accordance with the International Private Equity and Venture Capital Investor Reporting Guidelines issued by the IPEV Board, including a valuation of the portfolio at fair value.

iv Solicitation

Private equity funds are typically marketed by way of private placement, relying on the exemptions from prospectus requirements available under Italian law.[16] Marketing is defined by law as any 'direct or indirect offering of units or shares of an AIF at the initiative or on behalf of its managing AIFM to investors domiciled or with a registered office in the Union'. No guidance as to what 'indirect' means in this definition is provided by regulatory authorities; however, it is sensible to assume that no 'offering' is made until the constitutive documents of a fund are in final form and a firm and binding commitment to the fund can be made by an investor. Reverse solicitation is not a legally defined term and no regulatory guidance on this concept is available. As a practical matter, a fund manager should not rely on reverse solicitation unless it has clear evidence that the initial contact with a potential investor in respect of a given fund was made at the initiative of the investor itself. Because offering fund interests in breach of the applicable regulatory provisions is a criminal offence, a manager should act cautiously when relying on reverse solicitation. These concepts will (indirectly) acquire a more precise meaning by effect of recently adopted EU legislation on cross-border distribution of funds,[17] introducing the legal notion of 'pre-marketing' and becoming applicable from 2 August 2021.

A full-scope SGR must notify Consob of its intention to market a fund in Italy indicating whether the fund is also expected to be marketed to professional investors in other EU Member States under the AIFMD. The notification must enclose the governing documents of the fund, the offering document and other documentation as indicated in Annex III or IV of the AIFMD, as applicable. Marketing activities can commence after Consob, having verified that the documentation complies with the AIFMD and its implementing provisions, issues a no-objection letter. This process takes some 30 days to complete. Sub-threshold managers are

16 These exemptions include offerings made to certain qualifying financial intermediaries established by Consob or to a number of potential investors (excluding the intermediaries) not exceeding 150 or to parties investing €100,000 or more.

17 This legislative package includes Directive (EU) 2019/1160 amending the AIFMD and UCITS and Regulation (EU) 2019/1156 amending, inter alia, the EuVECA Regulation.

not required to go through this process to market their funds in Italy but do not benefit from the AIFMD passport provisions. Managers of EuVECA funds may market their funds in all EU Member States to professional investors and retail investors that commit to investing a minimum of €100,000 under the provisions of the EuVECA Regulation, as amended.

When seeking commitments to a fund, the manager must provide potential investors with the prescribed pre-contractual information, the offering document and (if fund interests are also offered to retail investors) the KID (see Section II.iii). Before accepting subscription agreements the manager must also comply with other requirements, including making appropriateness checks under the MiFID provisions and carrying out customer due diligence procedures under anti-money laundering and counter terrorist legislation. Special regulatory provisions apply when fund interests are offered to retail investors in Italy outside the principal or branch offices of the manager or of a licensed placement agent. These offerings must be carried out acting through licensed tied agents. Also, retail investors must be given the right to withdraw from their subscription agreements without paying any indemnity during a seven-day delay from the date of execution. Any breach of these provisions would make the agreements null and void.

Placement agents are frequently engaged by managers when marketing funds to non-Italian potential investors. Placement agents are instead rarely involved in a purely domestic fundraising.

Under the passport provisions implementing the AIFMD, full-scope EU AIFMs can market their EU AIFs to Italian professional investors and retail investors making a commitment to the fund of €500,000 or more. When transposing the AIFMD into law Italy cancelled its national private placement regime, which was then permitting the marketing of non-Italian AIFs by non-Italian AIFMs to Italian investors subject to an authorisation of the Bank of Italy. As a result, AIFs managed by non-EU AIFMs and non-EU AIFs managed by EU AIFMs may not be currently marketed to Italian investors. This marketing will be permitted when the third-country passport provisions of the AIFMD take effect with the adoption of the relevant delegated acts by the EU Commission (or in the context of the AIFMD review).

v Fiduciary duties

Italian AIFMs (SGRs and internally managed SICAFs) are required by law to act diligently, correctly and in a transparent manner in the best interests of the AIFs they manage, their investors and the integrity of the market. They must also: (1) be organised in a manner that minimises the risk of conflicts of interest and, in the event of a conflict, to ensure the AIFs they manage receive fair treatment; (2) adopt appropriate measures to safeguard the rights of the investors in the AIFs they manage and have adequate resources and adopt appropriate procedures to ensure efficient performance of their services; (3) in the case of reserved AIFs, give preferential treatment to individual investors or categories of investors only in accordance with the AIFMD; and (4) exercise the voting rights attached to financial instruments held by the AIFs they manage in the investors' interest.

III REGULATORY DEVELOPMENTS

i Regulatory agencies

The Bank of Italy is empowered to issue regulations determining the activities that may be carried out by Italian managers and establishing their legal duties and requirements within the framework of primary legislation applicable to them. Matters covered by Bank of Italy regulation include minimum capital, own funds, risk management, permitted holdings, corporate governance and organisational requirements (including control functions), outsourcing of key functions and services, remuneration and incentive systems and safekeeping of assets. Also, AIFs are subject to the regulatory powers of the Bank of Italy that cover matters such as investment diversification, limitation of risk, format of financial statements, valuation of assets and conditions to satisfy when valuation functions are delegated to an outsourcer. The Bank of Italy authorises Italian entities to carry out collective portfolio management services and keeps the roll where they are registered.

Consob is empowered to issue regulations concerning the duties of transparency and fair business conduct of fund managers in the provision of collective portfolio management services. No objection letters permitting Italian managers to market their AIFs under the provisions implementing the AIFMD are released by Consob. Other regulatory powers of Consob cover matters including inducements, conflicts of interest, personal transactions, complaints handling and knowledge and competence of personnel.

Within their respective remits, the Bank of Italy and Consob have regulatory oversight for Italian managers and AIFs.

ii Authorisation

Authorisation requirements applicable respectively to SGRs and internally managed SICAFs are dealt with in Section II.i in relation to contractual funds and SICAFs. The establishment of reserved AIFs of a contractual nature is not subject to authorisation, registration or any similar requirement; however, their governing rules must be delivered to the Bank of Italy as a reporting requirement. The authorisation requirement applicable to externally managed SICAFs is dealt with in Section II.i in relation to SICAFs.

iii Taxation

Tax exemption at fund level

Italian tax rules consider all AIFs opaque (i.e., non-transparent) entities, regardless of their legal form (i.e., both contractual funds and SICAFs), and treat them as separate taxable persons for Italian purposes. To avoid double taxation, AIFs are fully exempt from income taxes in respect of profits and gains realised in respect of their investments. An exemption applies also in respect of other direct taxes, such as the regional tax on productive activities, although funds established in corporate form (i.e., SICAFs) remain subject to the regional tax on certain management and subscription fees.

No tax ruling is required for this tax regime to apply. Any AIF established in compliance with Italian laws, regardless of whether it is managed in Italy or elsewhere, is considered tax-exempt and is treated as resident in Italy for domestic purposes (as such, it could in theory also avail itself of tax treaties signed by Italy).

The Italian tax authorities have confirmed that, after the implementation in Italy of the AIFMD, AIFs should be subject only to the tax laws of the jurisdiction in which they are established and that, accordingly, the fact that a non-Italian AIF could be managed by an Italian SGR does not trigger per se the application of Italian tax rules on the AIF itself or on its investors.

Taxation of investors

While AIFs are exempt, income taxes in principle apply at the level of their investors. Italian tax rules characterise as 'income from capital' all profits and gains derived from the investment in AIFs. Such income is subject to a withholding tax, which is levied at the standard rate of 26 per cent (although lower rates or exemptions apply in respect of certain investors) in the following cases: distributions, sale or redemption of the fund units or shares, and liquidation of the fund.

The taxable base includes all proceeds effectively distributed to the investors, as well as the balance between the value of the units or shares upon sale or redemption or liquidation of the fund and the subscription or purchase value of the same units or shares. The withholding tax is provisional or final, depending on the nature of the investor. In general, with some exceptions, it is a final levy for all resident investors not acting in a business capacity and for non-resident investors.[18]

However, the following eligible non-resident investors satisfying specific procedural requirements are entitled to a full exemption from the domestic withholding tax:

a certain international entities established in accordance with international treaties;

b central banks or similar entities;

c investors resident for tax purposes in a whitelisted country (i.e., a jurisdiction that is recognised by a special regulation as having in place with Italy an effective exchange of information for tax purposes); and

d institutional investors established in a whitelisted country (this definition includes entities whose activity consists of investing or managing investments, for their own benefit or on behalf of third parties, regardless of their legal status or tax treatment in the country of establishment).

As a result of the recent international trend of enhanced cooperation between tax authorities, the great majority of foreign jurisdictions have now been included in the Italian whitelist (originally approved by Ministerial Decree of 4 September 1996), which now comprises 134 countries.

In practical terms, most foreign investors are nowadays allowed to rely on the exemption on proceeds of the Italian AIFs in which they invest.

VAT and other indirect taxes

Fees charged for management of AIFs and certain related services are exempt from VAT, while fees due for custodian and controlling activities are subject to the standard VAT rate (currently 22 per cent).

18 A full exemption applies to Italian and foreign investors holding units of Italian (or EU or whitelisted European Economic Area) venture capital funds that invest at least 85 per cent in certain qualifying SMEs (in one of the following phases: seed financing, start-up financing, early stage financing, expansion or scale-up financing), provided that a number of other statutory conditions are met. The definition of eligible venture capital funds and the identification of qualifying SMEs, as well as the other conditions for benefiting from this exemption, have recently been updated in the 2019 Budget Law.

VAT rules in principle apply also to transactions carried out by a SICAF or by an SGR on behalf of contractual funds under management. The investment activities of private equity funds, however, generally fall within the scope of the VAT exemption for financial services (this also entails that input VAT paid in respect of certain services received is not recoverable).

Stamp duty

Neither the set-up of AIFs, nor the subscription or sale of their units are subject to any proportional *ad valorem* registration taxes or similar duties.

An annual stamp duty, at the proportional 0.2 per cent rate, may apply to the net asset value of AIFs units or shares, as resulting from their financial statements. This is, in practice, a wealth tax, which applies to all financial investments of certain investors and which is levied by the financial intermediaries involved with holding such investments. For investors other than individuals, this stamp duty is in any case capped at €14,000 per year (although many investors are de facto fully exempt because they do not fall within the subjective scope of application of the stamp duty).

Carried interest

Until 2016, there were neither statutory rules nor revenue guidelines specifically dealing with the Italian taxation of carried interest schemes of private equity funds. Careful planning was therefore required to efficiently structure the carried interest for managers of Italian AIFs, having regard to general income tax rules and principles that provided only limited guidance to distinguish between employment-related income (taxable at marginal progressive income tax rates, up to 43 per cent plus surcharges) and investment income (subject to a flat rate of taxation at 26 per cent).

Typically, Italian fund structures set up in past years required an actual financial investment (in most cases ranging between 1 per cent and 3 per cent of the total commitments raised) to be made by the managers in special classes of units or shares of the AIFs that give right to special distributions representing the carried interest entitlement.

In general, the proceeds received by the managers from their investment in these special classes of units of the AIFs were (and still are, subject to certain conditions) characterised as investment income and taxed accordingly. However, the notion of employment-related income laid down by Italian tax rules is very broad, so that the distinction is not always clear-cut and there remains a grey area, where possible concerns could easily arise.

In recent years, the private equity fund industry submitted various proposals to the Italian lawmakers and to the tax authorities to obtain the approval of a special safeguarding rule setting clearly the terms and conditions for the full assimilation of this investment to other financial investments.

After various discussions, in April 2017 the government approved a law decree containing special tax rules for the characterisation and taxation of carried interest, which were subsequently confirmed by the Italian parliament. According to the new provisions (which de facto operate as 'safe-harbour rules', as clarified also by the Italian tax authorities) income from direct or indirect participation in companies, entities or investment funds (including AIFs) established in Italy, or in a jurisdiction allowing an adequate exchange of information, arising from shares or other similar financial instruments granting enhanced economic rights (i.e., the carried interest shares or units), will be deemed, by operation of law, as investment income subject to a flat rate of taxation at 26 per cent.

This safe harbour regime applies, as far as AIFs are concerned, provided that all the following conditions are met:

a the carried interest holders collectively invest in the AIF (directly or indirectly) an amount of at least 1 per cent of the total commitments (including also investments in ordinary shares or units);

b the carried interest distributions are subordinated (i.e., they become due only when all the other investors have received a return equal to the invested capital plus hurdle); and

c the special shares or units to which carried interest distributions are attached are held for at least five years.

If one or more of the above conditions cannot be met, the carried interest could still be considered as investment income, subject to a case-by-case analysis and to careful planning and scrutiny. In this respect, the Italian tax authorities have already issued interpretative guidelines (addressing cases where one or more conditions set by the new rules are not satisfied) and have confirmed that they are willing to analyse and provide their view on specific situations if a ruling application is submitted to them.

Special tax incentives available to managers (individuals) relocating to Italy

Managers of private equity funds who plan to relocate to Italy, either for personal reasons or in the context of the establishment of an Italian office of the firm for which they work, can benefit from various tax advantages, which have been extended and made much more appealing, starting from 2017.

The first set of rules that could be of interest for such managers (especially for those moving to Italy to perform a working activity within the country) are those for inpatriate workers. In a nutshell, these rules, as recently modified, starting from fiscal year 2019 for workers who have already moved their fiscal residence in Italy as at 30 April 2019, and who meet the conditions for benefiting from this regime, grant a 70 per cent exemption from personal income taxes, for up to five years (which could be extended for an additional five years if certain conditions are met)[19] to qualifying new residents in respect of income that they earn from employment or from self-employment activities performed in Italy.[20]

Other very favourable tax incentives are provided by the new 'flat-tax regime', which allows individuals wishing to move their tax residence to Italy to pay an annual flat tax rate of €100,000 in respect of income and gains of any nature (with very limited exceptions) arising from foreign sources (i.e., produced outside Italy);[21] in practical terms, only income and

19 This extension is possible to the extent that the inpatriate worker: (1) has at least one child under the age of 18 or who is not economically independent; or (2) has acquired a residential property in Italy, after the relocation, or in the previous 12 months. During the additional five fiscal years, the exemption is limited to 50 per cent of the employment or self-employment income, but this can be increased to 90 per cent in certain cases (e.g., for inpatriate workers with three children under the age of 18 or with any that are not economically independent).

20 The eligible employee or self-employee who moves his or her fiscal residence to Italy may benefit from this special tax regime if he or she: (1) has not been resident in Italy in the two fiscal years prior to the transfer and undertakes to reside in Italy for at least two fiscal years; or (2) performs his or her professional activity mainly in Italy.

21 The benefits of the flat-tax regime may also be extended to other eligible family members by paying an additional €25,000 per year in respect of each additional relative.

gains from Italian sources, if any, remain subject to ordinary income taxes.[22] This regime is therefore very appealing to persons who do not have significant business interests in Italy, or whose working activity or source of income is predominantly based outside Italy; as a matter of fact, a few managers of non-Italian private equity firms have already moved their personal residence to Italy to take advantage of the flat-tax regime, which is available to any individual who has not been fiscally resident in Italy for at least nine of the previous 10 fiscal years. The option of this special regime can be taken year after year, for a maximum of 15 years. A ruling can be obtained by managers interested in assessing whether the flat-tax regime can be applied to them and the specific effects of the regime in respect of their personal situation (e.g., as concerns carried interest structures set up prior to their possible relocation to Italy).

iv Key changes to the regulatory regime

Recent regulatory changes affecting the Italian private equity and venture capital industry include the recast of MiFID (MiFID II),[23] the revision of the EuVECA Regulation[24] and the EU Regulation on key information documents for packaged retail and insurance-based investment products (the PRIIPs Regulation).[25] These regulatory changes originate from EU legislation. Implementing legislation was introduced in Italy in 2017 and subsequent regulatory provisions were published by Consob in 2018 and by the Bank of Italy in 2019.

Under the provisions on product governance implementing MiFID II, Italian fund managers are required to identify the target market and to define the distribution strategy for each fund they plan to establish and market by using five cumulative criteria:[26] (1) the type of client (according to the client categorisation as 'retail client', 'professional client' or 'eligible counterparty', as applicable); (2) the client's knowledge and experience; (3) the client's financial situation and ability to bear losses; (4) the risk tolerance and compatibility of the risk or reward profile of the fund with the target market; and (5) the client's objectives and needs. If the fund is marketed through a distributor subject to the above MiFID II product governance requirements, the fund manager is expected to provide the distributor with reliable and adequate information on the product for the distributor to properly discharge its duties concerning the definition of the target market and distribution strategy for the fund. MiFID II implementing provisions also require fund managers to provide investors with much more detailed pre-contractual information on risks, costs and associated charges.

The 2013 EuVECA Regulation was designed to introduce a simplified regime for establishing funds making qualifying investments in innovative SMEs and for marketing them on an EU-wide basis. As the number of EuVECA funds registered in the first three years following the introduction of this regime was below the expectations, the EuVECA

22 Applicants for the flat-tax regime are also fully exempt from (1) Italian wealth taxes on real estate and financial investments held abroad, (2) Italian gift and inheritance taxes on the value of foreign assets and investments, and (3) reporting and filing obligations in relation to the Italian tax authorities in respect of such foreign assets.

23 Directive 2014/65/EU (recasting Directive 2004/39/EC as amended) as supplemented by Commission Delegated Directives (EU) 2017/565 and 2017/593.

24 Regulation (EU) 2017/1991 amending Regulation (EU) No. 345/2013.

25 Regulation (EU) No. 1286/2014 (as amended by Regulation (EU) 2016/2340) as supplemented by Commission Delegated Directive (EU) 2017/653 on key information documents for packaged retail and insurance-based investment products.

26 In accordance with the ESMA Guidelines on MiFID II product governance requirements of 2 June 2017 (ESMA35-43-620).

Regulation was amended in 2017 to eliminate some perceived obstacles to a wider diffusion of these funds. Under the amended Regulation – effective since 1 March 2018 – the establishment of EuVECA funds is no longer reserved to sub-threshold managers, as in the previous regime: also authorised full-scope AIFMs are able to establish and market these funds using the EuVECA simplified passport regime. In addition, (1) eligible investments include companies with up to 499 employees (249 in the previous regime) not admitted to trading on a regulated market or on a multilateral trading facility, and SMEs listed on SME growth markets, and (2) EU authorities in the jurisdictions where EuVECA funds are marketed are no longer allowed to impose fees or other charges on EuVECA managers if no supervisory task is to be performed.

Pursuant to the PRIIPs Regulation and its implementing provisions (effective since 3 January 2018), fund managers are required to deliver a KID to retail investors before a fund is marketed to them. The KID is an easy-to-read short-form document (maximum three A4 pages) containing key information on the fund in a prescribed format. Its sections include information on the type of product and its objectives, a summary risk indicator (supplemented by a narrative explanation of the indicator), a performance scenario, whether the investor may face a financial loss because of the default of the manager, the direct and indirect costs associated with an investment in the fund (also presented by means of summary cost indicators), the recommended holding period and the steps to be followed for lodging a complaint. Information about the cumulative effect of costs on return to be provided to investors pursuant to the implementing provisions of MiFID II partly overlaps and should be coordinated with information on costs to be included in the KID.

IV OUTLOOK

The Italian private equity industry is currently facing a transition period. A number of investment teams that raised large funds attracting commitments from primary international limited partners (LPs) in the early part of the 2000s have been unable to consolidate their market position in the subsequent decade – because generational turnover issues were not managed adequately or for other reasons – and have split into smaller teams or just closed down. In a domestic scenario where there continues to be little institutional capital invested in the PE sector, as compared to other countries, established teams now manage smaller funds generally than those of their predecessors (with some exceptions). Also, the global trend towards concentration of capital into a smaller number of top-performing managers (with larger commitments compensating for the increased costs and efforts involved in carrying out deeper due diligence scrutiny) is indirectly raising barriers to the further growth of regional managers falling below the radar screen of most large international LPs.

The local industry is essentially composed of fund managers investing in the various segments of the domestic mid-market. These include several established players managing fund III or IV and having the right profile (track record, deal flow, disciplined investment strategy, team cohesion, size, etc.) to raise funds both in the domestic market and from international investors. Over time, a few of them created multi-jurisdictional teams and structures developing an ability to also invest funds in other European countries (typically, the United Kingdom, France, Germany and Spain). Other notable players in the Italian market are managers of large funds promoted by the public sector and mostly backed by significant capital commitments of Cassa depositi e prestiti, which are active in areas and investment strategies viewed as critical for the national economy (strategic businesses, infrastructures, turnaround, venture capital, etc.). Recently, unregulated investment schemes pooling capital contributed on a deal-by-deal basis mostly by family offices and high-net-worth individuals have become more popular, and a number of these schemes have been set up.[27]

While this scenario is unlikely to evolve quickly, some legal developments plan to have an impact on the industry in the short term. Tax measures were introduced in recent years (and have been modified several times) to incentivise direct and indirect investments in Italian business entities (and in European Economic Area (EEA) business entities with a permanent establishment in Italy) and to foster innovation. The most important ones are as follows.

a Since 2017, individuals not acting in a business capacity who invest money[28] in certain individual savings plans (PIRs) benefit from a tax exemption on all income and gains deriving from their long-term[29] investment. To this end, at least 70 per cent of the PIR's assets must be invested in financial instruments (equities or bonds) issued by the above entities, and a proportion of such assets must be in financial instruments issued by entities not included in the main index of the Italian Stock Exchange, Borsa Italiana (FTSE MIB), nor in equivalent indexes of other regulated markets. These requirements may also be met indirectly, by investing in PIR-compliant funds.[30]

b Pursuant to 2019 legislation, a special tax treatment will also be available (from 2020) to resident individuals investing in European long-term investment funds established under Regulation (EU) 2015/760 that invest at least 70 per cent of their commitments in eligible instruments issued by certain Italian-resident companies or EEA companies with an Italian permanent establishment, provided that certain additional conditions and limitations are met.[31]

These tax measures – intended to support the financing of local businesses by individuals – cross with a wider non-tax driven trend involving an ever-increasing offering of fund products tailored to the needs of retail investors seeking exposure to private capital markets (in Italy and abroad), where asset managers and private banks join forces to exploit this new market segment.[32]

Venture capital funds focusing on the domestic market also benefit from tax incentives, based on legislation initially introduced in 2011. Subject to specific statutory conditions, Italian and foreign investors are fully exempt from income taxes in respect of profits and gains deriving from investments in Italian (or EU or whitelisted EEA) venture capital funds that

27 These include Equity Partners Investment Club, promoted by Mediobanca, and Space Capital Club, which was established in 2019.

28 Up to €30,000 per year and €150,000 over five years.

29 PIRs must hold qualifying investments for at least five years.

30 A similar tax benefit is available to pension funds investing up to 10 per cent of their assets in PIRs or in the equity of Italian companies or EEA companies with a permanent establishment in Italy or in Italian or EEA funds that invest primarily in the equity of such companies (provided that these investments are held for at least five years).

31 This tax treatment provides for a tax exemption on all future profits and gains and an exemption from inheritance tax.

32 Azimut Demos I (€350 million), Fideuram Alternative Investments - Mercati Privati Globali (in partnership with Partners Group – €530 million) and Mediobanca Private Markets Fund I and II (Irish ICAVs managed by Russell Alternative Investments and distributed by Mediobanca – US$250 million) are among the Italian and non-domestic fully paid-in funds investing in private capital markets that were offered in Italy by private banks in 2019.

invest at least 85 per cent of their assets in certain qualifying SMEs in accordance with one of the following strategies: seed financing, start-up financing, early stage financing, expansion or scale-up financing.

Other ongoing and future developments that are expected to affect the industry structure include the following.

In Italy, the categories of permitted investors in a reserved AIF are likely to be modified in the near future. In addition to professional investors (and to directors and employees of the AIFM), these currently include retail investors committing €500,000 or more to the AIF (see Section II.i). The €500,000 threshold has been criticised by the industry as too high, given that non-reserved AIFs are also subject to strict prudential requirements that are not compatible with the features of many AIFs, including private equity and venture capital funds. The Italian regulators are considering different protections for retail investors wishing to invest in reserved AIFs, focusing on the requirement that their admission as investors is based on suitability assessments carried out under MiFID II. It is anticipated that, with the introduction of this requirement, the €500,000 threshold will be eliminated or substantially reduced.

After the recent revision of the EuVECA Regulation,[33] Italian managers wishing to market their funds in additional EU jurisdictions begin to consider the registration as EuVECA managers a viable alternative to the AIFMD passport, in light of the relaxed provisions on eligible investments. Indeed, the formal requirements associated with using the EuVECA passport are simpler than those applicable under the AIFMD, and the provisions protecting managers against fees charged by EU authorities in the jurisdictions where EuVECA funds are marketed will be viewed as an additional benefit.

Integrating environmental, social and corporate governance (ESG) considerations in the investment decision-making process is the industry's new mantra, with an increasing number of Italian institutional investors and fund managers signing the United Nations Principles for Responsible Investment and a growing number of funds being promoted as actively pursuing sustainable investments.[34] This trend is expected to be further accelerated by recent ESG legislation and EU initiatives, including Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector, which will become applicable from 10 March 2021.

33 See Section III.iv.

34 As a recent example, the Italian Association of Insurers launched Fondo Infrastrutture Italia, a private equity infrastructure fund that will be managed by F2i and will select investments in accordance with strict ESG criteria. The fund raised commitments for €320 million at its first closing in February 2020.

Chapter 9

JAPAN

Mikito Ishida[1]

I GENERAL OVERVIEW

Despite the situation with the covid-19 pandemic, the fundraising market for private equity funds in Japan remains strong. Due to the negative interest rate policy that has been present in Japan since 2016, investors such as regional banks are showing a strong appetite for alternative investments that will provide a meaningful level of return on investment. Although there are no official statistics on the fundraising market in Japan, we have noticed increasing demand from various private equity funds in the past years through our fund formation services. With respect to domestic Japanese funds, according to an article from 1 December 2021 in the *Nikkei* newspaper, the total amount of commitments to the domestics funds established in 2021 exceeded ¥600 billion and became the largest amount raised by domestic funds in a year. Japanese institutional investors have shown stronger interest in global private equity funds as well. Japanese pension funds and universities have shifted, or are willing to shift, a certain portion of their asset allocation to private equity and venture capital firms. Perhaps driven by the same reason, we have seen an increasing demand for fund of funds, which invest in various private equity firms.

II LEGAL FRAMEWORK FOR FUNDRAISING

i Japanese fund vehicles

There are several vehicles available under Japanese law that are used for private equity funds. Each has different characteristics, as explained further below.

Partnership

A partnership is a primitive pass-through vehicle recognised under the Civil Code of Japan. It is often called an NK from the abbreviation of its Japanese name. Both the fund operator and investors will be partners in the NK. As a principal rule, all partners share profits and risks (losses) of the partnership, and all partners bear unlimited liability to third parties. Because investors wish to avoid unexpected losses, investors and the fund operator typically agree in the partnership agreement that the ultimate risk is borne by the fund operator. Nevertheless, a third party that enters into a transaction with the partnership is able to make a claim against the investors for losses, which may not be welcomed by some investors.

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Investment limited partnerships

An investment limited partnership (ILP) is a partnership based on a special law (the Act on Investment Limited Partnership Agreements) enacted by the government in 1998 for the purpose of fostering investment funds in Japan. The ILP is based on the Civil Code partnership (NK), with several characteristics added by the special law. The most important characteristic of an ILP is that the investors, which will be limited partners of the ILP, bear limited liability. The liability of a limited partner is limited to the extent of its capital contribution to the ILP. The fund operator will be the general partner and bears unlimited liability to third parties in respect of the liabilities of the ILP. The ILP is the most frequently used fund vehicle in Japan. However, an ILP is prohibited from investing 50 per cent or more of its assets in foreign corporations. Once an ILP is formed, registration is required in the commercial registry within two weeks.

Limited liability partnerships

A Japanese limited liability partnership (Japanese LLP) is another variation of partnership based on the Civil Code partnership (NK), where each partner will only bear limited liability in respect of the liabilities of the fund. One important requirement of the Japanese LLP is that all partners must actively participate in the partnership activities, and mere passive cash investment is not permissible. Therefore, a Japanese LLP is not suitable for private equity funds that intend to raise money from various institutional investors. Instead, if there are only to be a limited number of investors, each of which is willing to actively participate in the investment activities of the fund, as may be the case with corporate venture capital, a Japanese LLP is a worthwhile option to consider. A Japanese LLP is also required to make a commercial registration within two weeks of its establishment.

Silent partnership

Another choice of fund vehicle is the silent partnership, which is more commonly known by its abbreviation 'TK'. A TK is recognised under the Commercial Code of Japan, and it is a contractual relationship formed by an agreement between the TK operator and the TK investor. In a TK, the TK investor makes a contribution to certain business of the TK operator (TK business), and the TK operator distributes profits arising from the TK business to the TK investor. The money contributed by the TK investor belongs to the TK operator, and all activities of the TK business are conducted by the TK operator in its own name (and not in the name of the fund). The TK investor does not hold any direct interest in the assets comprising the TK business, and the liability of the TK investor is limited to the extent of its contribution. There are no registration requirements when forming a TK.

Tax treatment of a TK differs from other pass-through partnerships, especially if the investor is an individual. A TK is often used together with a Japanese limited liability company (GK), which will be the TK operator.

ii Characteristics of Japanese fund contracts

Model agreement form

Japanese fund contracts[2] generally follow the structure of global fund contracts in many respects, such as the management fee and carried interest structure. However, some of the terms and conditions widely accepted in Japanese fund contracts differ from globally recognised terms. The reason for this is because most Japanese ILP fund contracts are based on the model agreement form provided by the Ministry of Economy, Trade and Industry (METI), and some of the content of the model agreement form is not totally aligned with that currently considered to be global standard, especially compared with the terms and conditions of complicated fund agreements adopted in global private equity funds.[3]

Organisation for Small & Medium Enterprises and Regional Innovation requirements

Another characteristic of Japanese ILP fund contracts is that many agreements contain specific terms related to the Organisation for Small & Medium Enterprises and Regional Innovation (SMRJ). The SMRJ is a government-related administrative agency that invests in private equity funds, and a large number of Japanese funds are currently being invested in by the SMRJ (as a limited partner). The SMRJ requires that the funds into which it invests must have certain terms stipulated in its investment rules, such as a requirement that a certain portion of the fund's portfolio investments are made in small and medium-sized enterprises.

iii Overview of fundraising regulatory framework

Prior to the introduction of the Financial Instruments and Exchange Act of Japan (FIEA) in 2007, partnership interests were not considered to be 'securities' under the securities laws in Japan, and there were very limited restrictions on fundraising by partnerships. However, an interest in a fund is now categorised as a security under the FIEA, and is subject to its regulation. The Japanese regulations on private equity funds differ depending on the fund structure (i.e., whether it is a partnership-type fund or a corporation-type fund).

iv Regulations on partnership-type funds

Partnership-type funds are the main vehicle used for fund formation in Japan. Partnership interests are recognised as being interests in a collective investment scheme,[4] which fall within the securities enumerated in the FIEA. Therefore, a partnership involving Japanese investors, regardless of whether its general partner is located outside Japan and the limited partnership is established outside Japan, is subject to regulation under the FIEA in that the general partner may be required to register or to file a notification, as the case may be, with the Financial Services Agency (FSA), the relevant Japanese regulatory authority, both in respect of (1) its offering activities in Japan or to Japan-resident investors (the Offering Regulations) and (2) its investment management activities for a fund involving Japanese investors (the Investment Management Regulations).

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2 Because ILPs are the most frequently used vehicle for Japan-based private equity funds, this section focuses on the terms of ILP contracts.

3 The latest version of the model agreement form published in 2018 is only available in Japanese, although the previous version of the model agreement form published in 2010 has an English translation.

4 See Article 2(2)(v) and 2(2)(vi) of the FIEA for a further definition of collective investment schemes.

The Offering Regulations and the Investment Management Regulations are generally structured under the concept that the offering activities and investment management activities are conducted by the general partner of the fund, rather than by the manager of the fund. Therefore, registration or filing required under the Offering Regulations or the Investment Management Regulations is typically required to be made by the general partner of the private equity fund.

Offering Regulations

Under the Offering Regulations, in principle, to solicit partnership interests of a private equity fund in Japan, the general partner of the fund must register with the FSA as a Type II financial instruments business operator. However, registration as a Type II financial instruments business operator is a document-intensive and time-consuming process and generally requires several months of preparation. Therefore, a majority of fund operators typically utilise the Article 63 exemption (see below), which is one of the exemptions set out in the FIEA. With respect to foreign private equity funds, some fund operators may instead retain a Japanese firm that is already registered as a Type II financial instruments business operator (such as a securities firms) for the purpose of marketing the fund in Japan.

Investment Management Regulations

The Investment Management Regulations have the same structure as the Offering Regulations in that they generally require registration but have certain exemptions. In principle, a general partner that manages a fund that has a Japanese investor must register with the FSA as an investment management business operator. However, registration as an investment management business operator is likely to be even more time-consuming than registration as a Type II financial instruments business operator, and, hence, foreign private equity funds normally also seek to rely on exemptions from such registration.

Article 63 exemption

One of the frequently used exemptions from the registration requirement under the Offering Regulations and the Investment Management Regulations is called the Exemption for Special Business Activities for Qualified Institutional Investors, stipulated in Article 63 of the FIEA (the Article 63 exemption). A fund operator using this exemption is known as an Article 63 exempted operator. If the general partner can rely on this exemption, it can conduct offering activities in Japan and investment management activities for Japanese investors by filing a notification called a 'Form 20' with the FSA. Documents required for the Article 63 exemption can be prepared in English.

In a high-level summary, the Article 63 exemption requires that:

a at least one of the fund investors is a qualified institutional investor (QII);

b the number of Japanese non-QII fund investors is no more than 49;

c each Japanese non-QII fund investor is an eligible non-QII;

d the Japanese investors do not include investors that are considered to be disqualifying investors, such as certain types of collective investment schemes;

e the general partner submits a copy of its constitutional document;

f officers and certain employees of the general partner submit to the FSA their CV and certification of their compliance with the qualification requirements prescribed in the FIEA;

g the partnership interests are subject to certain transfer restrictions; and *h* if the general partner resides outside Japan, a representative in Japan (who will be in charge of communication with the FSA) is appointed by the general partner.

However, even if the above exemption applies, the general partner is still required to comply with certain ongoing obligations under the FIEA, including the following:

a submitting a business report together with its balance sheet and profit and loss statements to the FSA within three months of the end of each fiscal year;

b making certain excerpts from the Form 20 and the business report available to the public; and

c filing an amended Form 20 or submitting a copy of an amended constitutional document when any revision is made to the contents.

In addition, Article 63 exempted operators are subject to supervision and enforcement by the FSA, including reporting requirements, on-site inspections and business improvement orders or business suspension orders.

The Article 63 exemption has a fund-of-funds regulation that includes a look-through rule, and investors of upper-tier funds must also be counted against the threshold of 49 non-QII investors. Moreover, certain types of fund vehicles are prohibited from investing in a fund using the Article 63 exemption.

The entire list of Article 63 exempted operators is publicly available on the FSA's website.

QII

The QII is the key concept that needs to be considered in checking the applicability of the Article 63 exemption. Unless there is a Japanese investor that qualifies as a QII, it is difficult for the general partner of a private equity fund to be exempted from the registration requirement by utilising the Article 63 exemption. Various types of institutions that fall within the definition of a QII are prescribed in a cabinet office order under the FIEA. For example, Japanese banks and insurance companies are enumerated as QIIs. Companies and individuals that hold investment assets (securities) of no less than ¥1 billion can become QIIs through a filing with the FSA. Such filing must be renewed biennially. The list of QIIs is available on the FSA's website, so private equity funds can access the website and check whether the targeted Japanese investor is a QII or not. QIIs are considered to be professional investors under the FIEA and, therefore, some of the regulations are mitigated for financial transactions with QIIs.

Transfer restrictions

Another important concept of the Article 63 exemption is transfer restrictions. Transfer restrictions should be included in the partnership agreement or other executed documents to qualify for the Article 63 exemption from the Offering Regulations. The transfer restrictions should stipulate that QII investors may only transfer their partnership interests to other QIIs, and non-QII investors may only transfer their entire interest to a single investor that is a QII or an eligible non-QII.

De minimis Japanese QII exemption

If a non-Japanese private equity fund is marketing to Japanese investors, another exemption available is the *de minimis* Japanese QII exemption. If the requirements for this exemption are met, the general partner is exempted from both registration and filing of a notification with respect to the Investment Management Regulations.

The *de minimis* Japanese QII exemption requires that:

a the non-Japanese fund has fewer than 10 Japanese fund investors, whether directly or indirectly through a Japanese collective investment scheme;

b all Japanese direct and indirect fund investors are QIIs; and

c the aggregate capital contributions to the fund by such Japanese fund investors represent no greater than one-third of the aggregate capital contributions of all fund investors.

However, this exemption only applies to the Investment Management Regulations, and not to the Offering Regulations. Therefore, the general partner of a foreign private equity fund still needs to file Form 20 in respect of offering activities, unless all marketing activities in Japan for such fund are carried out by a registered placement agent (Type II financial instruments business operator) under the FIEA. A general partner may use the Article 63 exemption for the Offering Regulations and thereafter rely on the *de minimis* Japanese QII exemption for the Investment Management Regulations.

v Solicitation of non-Japanese corporation-type fund

In the case of a non-Japanese corporation-type fund, the solicitation of shares of such fund is typically delegated to and handled by a registered placement agent (Type I financial instruments business operator, such as a securities firm in Japan), and the fund itself does not conduct any marketing or offering to Japanese investors.

An investment fund established in the form of a company or a trust will likely be interpreted as a foreign investment corporation or foreign investment trust within the meaning of the Act on Investment Trusts and Investment Corporations (AITIC). Pursuant to the AITIC, prior to offering such company's shares in Japan, the issuer must file a notification with the FSA. The filing must be made in Japanese. Under the AITIC, the notification must contain information including details on the management and investments of the fund, the calculation of the net asset value of the fund and the distribution of profits.

The AITIC does not require that investment management reports be prepared or delivered to shareholders of foreign investment corporations (as opposed to foreign investment trusts).

vi Public offering

The information above generally assumes that the offering of interests in the fund qualifies as a private placement under the FIEA. However, if more than 499 limited partners subscribe for a partnership-type fund in Japan, for example, it will be subject to public offering disclosure regulations, and registration statements and other disclosure documents will be necessary for the offering of such fund.

vii Anti-Money Laundering Law

Pursuant to the Act on Prevention of Transfer of Criminal Proceeds, an Article 63 exempted operator must obtain certain documents prior to, or at the execution of, the subscription agreement of the fund with each Japanese investor for anti-money laundering purposes. In particular, there is certain information that must be obtained for purposes of investor identification. The Act also requires identification of the representative executing the fund subscription and identification of the 'effectively controlling person' of the investor. Furthermore, if a transaction is considered a high-risk transaction as stipulated in the Act (e.g., a transaction with certain foreign politically exposed persons), additional scrutiny of the identification of the investor will be required, and transactions having a suspicion of money laundering should be reported to the government authority. In addition, the Act requires record keeping with respect to investor identification procedures and transactions with investors.

viii Act on Sales of Financial Products

In accordance with the Act on Sales of Financial Products, a fund operator that conducts the business of selling financial products in Japan or to Japanese investors must explain certain important matters to investors prior to the sale of financial products. However, the fund operator does not need to provide such explanation to certain professional investors defined under the Act (which include QIIs), and the fund operator may also obtain consent from its investors that it does not need such explanation on certain important matters.

III REGULATORY DEVELOPMENTS

Reform of Article 63 exemption

In 2016, there was a major reform of fund regulations under the FIEA. After the amendment, requirements to qualify as an Article 63 exempted operator increased significantly. The following are the major new requirements.

Limitation of investors to eligible non-QIIs

Prior to the amendment of the FIEA in 2016, there were no required criteria for Japanese investors that were not QIIs. However, under the amended FIEA, for a fund operator to qualify for the Article 63 exemption, all of the Japanese fund investors need to fulfil certain minimum economic criteria or qualify as a person that is closely related to the fund, as enumerated in the FIEA (eligible non-QII). As a result, it became difficult for private equity funds to solicit individual investors other than those that are sufficiently wealthy to meet such criteria. The status of an eligible non-QII will be determined at the time of solicitation, and this status does not need to be maintained during the entire term of the fund.

Appointment of a representative in Japan

Another new requirement specifically for non-Japanese funds is the appointment of a representative. If an Article 63 exempted operator does not reside in Japan, it must appoint a representative in Japan. This representative needs to be a resident in Japan and can either be a natural person or a corporation. The representative should function as a contact person for communication with the FSA (or the Kanto Finance Local Bureau, which is, in practice, the contact point of the regulators).

Additional investor disqualification

Under the amended FIEA, an Article 63 exemption will not be available if either of the following criteria applies to the relevant fund during its term: (1) the only QII in the fund is an ILP, and such ILP has net assets under management of less than ¥500 million; or (2) 50 per cent or more of the fund assets contributed by all investors are contributed by investors with a close relationship with the Article 63 exempted operator (as further specified in the FIEA).

Additional documents for Form 20 filing

As a result of the FIEA amendment, an Article 63 exempted operator is required to submit its articles of incorporation (or other constitutional documents, such as an operating agreement of a Limited Liability Company (LLC)) and a statement letter that indicates that the Article 63 exempted operator is not disqualified from the Article 63 exemption as prescribed in the FIEA. In addition, officers and certain employees of the Article 63 exempted operator must submit an affidavit of certain personal information (e.g., name, address and date of birth), their CV and a statement letter certifying their compliance with the qualification requirements as prescribed in the FIEA.

Public disclosure by the Article 63 exempted operator or FSA

Public disclosure requirements have also been strengthened by the 2016 amendment. Without delay, after filing Form 20, an Article 63 exempted operator must make publicly available certain information excerpted from Form 20 on its website or by other methods that can be accessed easily by the public. The form of this disclosure is called Form 20-2 and is available on the FSA website.

The FSA will also disclose the contents of Form 20-2 to the public on its website, with respect to all Article 63 exempted operators.

Annual business report and disclosure booklet

Under the amended FIEA, Article 63 exempted operators must submit a business report (Form 21-2) for each fiscal year within three months of the end of such fiscal year. If the investors are limited to professional investors, certain information, such as composition of fund assets, may be omitted from the business report.

The Article 63 exempted operator must make publicly available a disclosure booklet (Form 21-3, which is an excerpt of the business report) at its office in Japan, on its website, or by other means, for a period of one year, commencing four months after the end of the relevant fiscal year.

Stricter compliance regulations

Prior to the amendment of the FIEA in 2016, Article 63 exempted operators were only subject to a limited number of compliance regulations, such as prohibition of making false statements and compensating losses incurred by investors. However, since 2016, Article 63 exempted operators have been subject to many compliance regulations that were historically applicable to registered financial instruments business operators only, including the following:

a delivering a notice to each professional investor stating that it has the option to change its status from a professional investor[5] to a non-professional investor;
b delivering certain explanatory documents explaining certain important risks of the fund, which should be delivered twice (prior to the subscription and at the time of subscription) to the investors that are non-professional investors;
c delivering an investment management report to non-professional investors periodically;
d keeping certain records of financial transactions, such as limited partnership agreements, subscription agreements and investment management reports, for a maximum period of 10 years;
e including provisions in the partnership or subscription agreement requiring the segregation of fund assets from the proprietary assets of the Article 63 exempted operator;
f notifying the FSA if the Article 63 exempted operator becomes subject to a lawsuit, or if a director or employee of the Article 63 exempted operator violates the law in respect of the relevant fund business;
g advertising by an Article 63 exempted operator must fulfil certain requirements, including a description of fees it charges; and
h complying with the duties of good faith and fairness, loyalty and care of a good manager.

Impact of covid-19 on Form 20 filing process

Prior to the covid-19 era, the filing of Form 20 required delivery of original signed hard copies to the FSA. However, because of the covid-19 pandemic and the fact that the Japanese government strongly pushed towards simplifying administrative procedures, the FSA currently accepts Form 20 filing via email (by attaching a PDF copy), on the condition that the originals are delivered to the FSA within approximately one month from the filing.

IV OUTLOOK

The number of private equity funds and venture capital funds in Japan has increased significantly in recent years. Reflecting this growth, as well as the variation and diversified use of fund vehicles, the regulators have continually tightened the regulations on private equity funds in Japan. We anticipate that restrictions on fund solicitation and fund management will likely further increase.

Another noteworthy trend is that Japanese financial institutions are starting to further scrutinise and monitor the internal compliance rules of private equity funds. This is partly because the bank leverage regulations now require Japanese financial institutions to check the investment policy of the private equity funds in which they invest, to lower the multiples applicable in the calculation of its risk-weighted assets. Lastly, the Japanese government announced in December 2020 that it will amend the rules on taxation of carried interest and will clarify that carried interest will be treated as capital gain if certain requirements (e.g., allocation of carried interest is economically rational) are met. This amendment should add more clarity on tax treatment for fund managers.

5 'Professional investor' is defined in the FIEA. Examples of professional investors are: QIIs, listed companies, Japanese corporations whose capital is reasonably expected to be no less than ¥500 million and foreign legal entities.

Chapter 10

LUXEMBOURG

Patrick Mischo, Frank Mausen, Jean-Christian Six and Peter Myners[1]

I GENERAL OVERVIEW

The Luxembourg asset management industry had another stellar year in 2019. We have seen a massive increase in the number of large private equity managers that have chosen Luxembourg as their European domicile of choice for the establishment of their funds and their alternative investment fund manager (AIFM). Some of the largest private equity firms worldwide have now chosen Luxembourg as their main European hub.

Several factors are contributing to the growth of the Luxembourg private equity industry. One of them is certainly the wide range of Luxembourg vehicles that are appropriate for structuring private equity funds. Most private equity funds that have been established in Luxembourg since 2013 have been established as unregulated vehicles, either as unregulated Luxembourg limited partnerships (LPs) or more recently as reserved alternative investment funds (RAIFs). Between December 2018 and January 2021, the number of RAIFs increased from 561 to 1,361.

Another factor is the convergence of regulatory and tax developments, in particular the Alternative Investment Fund Managers Directive (AIFMD) and the Organisation for Economic Co-operation and Development (OECD) action plan against base erosion and profit shifting (the BEPS Action Plan), which all point in the direction of an increased focus on the operational presence of the manager in the country where the funds and their special purpose vehicles are located.

II LEGAL FRAMEWORK FOR FUNDRAISING

Over the years, Luxembourg has developed an amazing toolbox of structuring solutions. Key milestones in that process are as follows:

a March 2004: creation of securitisation undertakings;

b June 2004: adoption of the investment company in risk capital (SICAR), a regulated vehicle specifically designed for investments into private equity;

c 2007: adoption of the specialised investment fund (SIF), a regulated vehicle appropriate for the structuring of any type of alternative investment fund (AIF), including private equity funds;

d 2013: overhaul of the Luxembourg LP regime, with a modernisation of the rules applicable to the common limited partnership (SCS) and the creation of the special limited partnership (SCSp); and

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e 2016: creation of the RAIF, a vehicle that is not subject to the direct supervision of the Luxembourg supervisory authority (CSSF) and may be used for the structuring of any type of AIF, including private equity funds.

i Unregulated LPs

Since 2013, the LP (in the form of an SCS or SCSp) has become the vehicle of choice for the structuring of Luxembourg funds investing in illiquid assets, including private equity. The Luxembourg LP regime offers wide structuring flexibility and enables sponsors to tailor the fund structure to fit their specific needs.

The main difference between SCSs and SCSps is that SCSps have no legal personality of their own, in contrast to SCSs, which do. The SCSp is, therefore, similar to an English LP, while the SCS is closer to a Scottish LP or a German KG. From a Luxembourg (legal and tax) standpoint (and for an AIFMD-compliant vehicle), the choice between an SCS and an SCSp has no material impact on how the Luxembourg LP will operate and interact with its partners and counterparties (and does not impact at all on the responsibility of investors, who benefit from limited liability in both structures). This choice is generally driven by investors' preferences. Anglo-American sponsors and investors are generally more familiar with the SCSp structure, which is closer to an English LP.

The SCS and the SCSp are two types of Luxembourg companies. LPs, therefore, do not have a regulatory status, and Luxembourg LPs (SCSs and SCSps) may, therefore, be established either under one of the specific product regimes available (SICAR, SIF or RAIF regimes) or outside those regimes (in which case they are generally referred to as 'unregulated LPs').

The key features of unregulated LPs are very similar to those of English, Scottish or US LPs. This enables Anglo-American sponsors to establish their Luxembourg funds in a format that they, and their investors, are familiar with. They use their standard documentation for the launching of their Luxembourg LP, with limited adjustments only. The unregulated LP may be used for the structuring of funds, feeder funds, parallel funds, co-investment vehicles or carried interest vehicles.

More and more private equity managers are establishing parallel fund structures with two separate funds, one in Luxembourg targeting European investors and the other in another jurisdiction targeting US investors, for instance. The unregulated LP regime offers the flexibility needed to ensure that the Luxembourg fund operates on the basis of the same principles as those that apply to the parallel fund.

Luxembourg LPs benefit from a number of attractive features that may not be available in all other jurisdictions. For instance, in certain jurisdictions, capital returned to limited partners is subject to a risk of clawback in certain circumstances. To limit that risk, limited partners' commitments are structured by way of a combination of a small amount of capital (exposed to the clawback risk) together with a large percentage of a non-interest-bearing loan. In a Luxembourg LP, capital returned to partners by way of distribution of dividends or reimbursement of partnership interests cannot be recalled, unless otherwise provided for in the partnership agreement. Investor commitments in a Luxembourg LP may, therefore, be structured by way of a 100 per cent capital contribution.

As is the case in most jurisdictions with an LP regime, limited partners in a Luxembourg LP may lose their limited liability if they intervene in the management of the LP. However, in Luxembourg this risk only arises if a limited partner carries out acts of external management, which entail an element of representation of the LP towards third parties. The Luxembourg

LP regime provides expressly that limited partners are not at risk of losing the benefit of their limited liability if they perform acts that are internal to the LP, such as exercising rights attached to the status of a partner in the LP, providing advice or consultation or controlling the business of the LP.

Unregulated LPs are not subject to the supervision of the CSSF. An unregulated LP may, therefore, be launched without the approval of the CSSF and no regulatory approval is required in relation to any of the steps to be performed during the life of the unregulated LP.

However, this does not mean that all unregulated LPs fall outside regulatory supervision. Unless they benefit from an AIFMD exemption (such as the *de minimis* exemption for smaller funds or the exemption for AIFs managed by a non-EU manager), unregulated LPs that are AIFs must be managed by an authorised AIFM and are, therefore, indirectly subject to regulatory oversight through their AIFM. This also means that, despite the absence of direct regulatory supervision, an unregulated LP that is managed by an authorised AIFM (whether in Luxembourg or in another EU Member State) fully benefits from the AIFMD marketing passport.

The new Luxembourg LP regime is extremely successful. However, the unregulated LP may not be the most suitable vehicle in all circumstances, as detailed below:

a First, unregulated SCSs and SCSps cannot avail themselves of the umbrella structure, and so cannot create segregated portfolios of assets and liabilities (compartments).

b Second, SCSs and SCSps are not subject to taxation (provided they can be regarded as AIFs or meet certain conditions that have been clarified by the Luxembourg tax authorities by way of Circular LIR No. 14/4 dated 9 January 2015) and a tax-opaque vehicle (with access to certain double taxation treaties) may be more appropriate in certain circumstances.

c Finally, LPs may in certain circumstances qualify as a hybrid entity because of their tax transparency under the European anti-hybrid rules, triggering unfavourable tax consequences. In that respect, the RAIF offers a wider range of legal and corporate forms to meet tax needs while remaining unregulated. In particular, the corporate governance characteristics of the partnership limited by shares (SCA) are very similar to those of the SCS and SCSp, with the main difference being that the SCA is a tax-opaque company. Similarly to the SCS and the SCSp, an SCA is managed by a manager or general partner, and its limited partners may participate in advisory or supervisory boards without being deprived of their limited liability.

ii RAIFs

The RAIF regime offers a solution to managers who want to avoid a double layer of regulation when setting up AIFs, while at the same time benefiting from the umbrella structure that, until the adoption of the RAIF, was reserved for regulated funds such as SIFs and SICARs. Also, RAIFs may be established either as tax-transparent or tax-opaque vehicles.

The RAIF is reserved for the structuring of funds that appoint a duly authorised AIFM, established in Luxembourg or in any other EU Member State.

RAIFs may be established under different legal forms, including that of a common fund or an investment company incorporated, among other corporate forms, as a public company, an SCA or an SCSp.

RAIFs must in principle comply with the risk-spreading principle, with a maximum concentration ratio in any single investment of 30 per cent. However, RAIFs that have the sole objective of investing in risk capital may be exempted from the risk diversification requirement and benefit from a tax regime that is similar to that applicable to SICARs. The concept of risk capital covers basically all types of private equity and venture capital strategies.

iii Securitisation undertakings

An additional and increasingly popular funding method in Luxembourg is securitisation, by which a Luxembourg securitisation undertaking acquires or purchases risks relating to certain claims, assets or obligations assumed by third parties, and finances the acquisition or purchase by the issue of securities, the return on which is linked to these risks.

Despite certain image problems of securitisation in general after the sub-prime crisis in 2007–2008, there has been a very positive development and steady growth of the Luxembourg securitisation market in the past couple of years. At the beginning of 2021, over 1,400 securitisation vehicles had been registered with the Luxembourg trade and companies register. Furthermore, this number does not accurately reflect the success of the Luxembourg securitisation market as Luxembourg law allows, as further described below, for securitisation vehicles to create several compartments. It has become the funding method of choice for more and more companies that own suitable financial assets.

The Luxembourg Securitisation Act of 22 March 2004, as amended (the Securitisation Act 2004) provides a complete and solid legal framework for the Luxembourg securitisation market and is considered as one of the most favourable and advanced pieces of European legislation for securitisation and structured finance transactions. The robustness and flexibility of this Act is highly appreciated by the international participants using Luxembourg as a hub to set up securitisation undertakings governed by Luxembourg law to access the capital markets.

The Securitisation Act 2004 distinguishes between regulated and unregulated securitisation undertakings. A securitisation undertaking must be authorised by the CSSF and must obtain a licence if it issues securities to the public on a continuous basis. Both regulated and unregulated securitisation undertakings benefit from all the provisions of the Securitisation Act 2004. A securitisation undertaking must mainly be financed by the issue of instruments (be it equity or debt securities) that qualify as securities under their governing law. The Securitisation Act also distinguishes between securitisation companies and securitisation funds that consist of one or more co-ownerships. Until now, the vast majority of securitisation undertakings adopted a corporate form. However, in light of the implementation into Luxembourg tax law of the new interest limitation rule, in accordance with the EU Anti-Tax Avoidance Directive (ATAD 1),[2] securitisation funds, which are not corporate income taxpayers, have gained in popularity. Securitisation undertakings may also issue securities in a fiduciary capacity, which is also a useful tool in the context of ATAD 1.

The Securitisation Act 2004 contains no restrictions regarding the claims, assets or obligations that may be securitised. Securitisable assets may relate to domestic or foreign, movable or immovable, future or present, tangible or intangible claims, assets or obligations. It is also accepted that a securitisation undertaking may, under certain conditions, grant loans directly. Very advantageous provisions for the securitisation of claims have been included in the Securitisation Act 2004.

2 Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market.

To enable the securitisation of undrawn loans or loans granted by the securitisation undertaking itself, the Luxembourg Act dated 5 April 1993 relating to the financial sector, as amended, exempts these transactions from a banking licence requirement. Furthermore, transactions that fall within the scope of the application of the Securitisation Act 2004 (such as, for example, credit default swaps) do not constitute insurance activities that are subject to Luxembourg insurance legislation.

The Securitisation Act 2004 allows the board of directors of a securitisation company or the management company of a securitisation fund to set up separate ring-fenced compartments. Each compartment forms an independent, separate and distinct part of a securitisation company's estate, or a distinct co-ownership of a securitisation fund, and is segregated from all other compartments of the securitisation undertaking. Investors, irrespective of whether they hold equity or debt securities, will only have recourse to the assets within the compartment to which the securities they hold have been allocated. They have no recourse against the assets making up other compartments. In the relationship between the investors, each compartment is treated as a separate entity (unless otherwise provided for in the relevant issue documentation). The compartment structure is one of the most attractive features of the Securitisation Act 2004, as it allows the use of the same issuance vehicle for numerous transactions without the investors running the risk of being materially adversely affected by other transactions carried out by the securitisation undertaking. The feature allows securitisation transactions to be structured in a very cost-efficient way without burdensome administrative hurdles. There is no risk-spreading requirement for compartments. It is, hence, possible to isolate each asset held by the securitisation undertaking in a separate compartment.

The Securitisation Act 2004 also expressly recognises the validity of limited recourse, subordination, non-seizure and non-petition provisions. Rating agencies are very comfortable with transactions structured under the Securitisation Act 2004 as legal counsel can usually issue clean legal opinions.

The Luxembourg legislature has clearly succeeded in transforming Luxembourg into one of the leading financial hubs for securitisation and structured finance vehicles by producing an attractive legal and tax framework for Luxembourg securitisation vehicles.

III TAX AND REGULATORY DEVELOPMENTS

In August 2018, the CSSF released Circular 18/698 on Luxembourg investment fund managers, which provides helpful guidance on the 'substance' and organisational requirements for approval as an AIFM in Luxembourg. Existing AIFMs had until the end of 2019 to adapt to the new rules.

The choice of a vehicle for the structuring of Luxembourg funds has become increasingly driven by tax considerations, in particular in light of the recent implementation (i.e., on 20 December 2019) into Luxembourg tax law of the second EU Anti-Tax Avoidance Directive[3] (the ATAD 2 Law).

The ATAD 2 Law contains a set of anti-hybrid rules that draw inspiration from the OECD BEPS Action Plan. The objective of these rules is to neutralise the tax effects of hybrid mismatches arising from different characterisations of a financial instrument or an entity

3 Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries.

under the laws of two Member States, or of one Member State and a third country. Indeed, the different characterisation of a financial instrument or an entity may, in particular, give rise to a situation of 'deduction without inclusion'. Payments made under a hybrid instrument or by a hybrid entity may be deductible in the country of the payer but may not give rise to an inclusion in the tax base in the country of the payee, nor in any other jurisdiction. The anti-hybrid rules allow the country of the payer to deny the deduction of such payments in a situation of deduction without inclusion.

In the context of Luxembourg funds, a tax-transparent LP may, in a private equity context, be considered tax-opaque by its investors (for instance, under the US check-the-box rules or in accordance with the investors' domestic rules regarding the classification of foreign entities for tax purposes) and thus fall within the definition of a hybrid entity under the ATAD 2 Law. The hybrid nature of the entity is, as such, not sufficient for the rule to apply. Checks would have to be made as to whether such hybridity gives rise to a negative tax effect, such as a situation in which deduction occurs without inclusion of payments made by a Luxembourg company held by the LP to the limited partners, or a situation of double deduction. Similarly, different characterisations of a financial instrument granted by a Luxembourg LP to an underlying Luxembourg company may, in a private equity context, give rise to negative tax effects, whereby the deductibility of the interest under the financial instrument could be denied at the level of the Luxembourg company held by the LP.

These rules will only apply between related or associated parties or in the context of a structured arrangement. An investor might be considered an associated entity in relation to the underlying Luxembourg company, in particular if it holds through the LP a direct or indirect interest of at least 50 per cent or more of the Luxembourg company. For the anti-hybrid rule on financial instruments to apply, the required threshold is reduced to 25 per cent. For the purposes of the associated parties test, one would need to aggregate the interest of investors who are acting together (e.g., investors belonging to the same company group, investors acting in accordance with the wishes of another investor or investors entering into an agreement on voting rights or equity interests). Investors normally invest independently from one another in the LP, they rarely enter into such agreements and they also do not exercise any control over the LP's investments. The ATAD 2 Law therefore provides for a rebuttable presumption according to which any investor in an LP (which qualifies as an investment fund) that holds, directly or indirectly, less than 10 per cent of the LP's interests and which is entitled to receive less than 10 per cent of the LP's profits is not considered as acting together with the other investors. On the basis of an *in contrario* reading of these provisions, one could argue that where several investors hold more than 10 per cent of the LP's interest or receive more than 10 per cent of the LP's profits, their interests should not automatically be aggregated for the purposes of calculating the relevant thresholds. Such investors must, however, be able to provide evidence that they are not effectively acting together regarding their interests or voting rights in the LP (e.g., they do not exercise any control over the investments realised by the LP and act independently from other investors with respect to their investment in the LP).

Finally, the ATAD 2 Law also sets out a 'reverse hybrid mismatches' rule, which will only apply as from 1 January 2022. This rule targets the hybrid entity as such (i.e., the LP itself), and not the deductibility of interest paid by a Luxembourg company to a hybrid entity. The rule provides that an EU resident entity (which is treated as tax-transparent in its country of residence but as tax-opaque in the country of its non-resident direct or indirect owners) will have to be treated as being tax-opaque in its country of residence. Consequently, it will become subject to tax on its income to the extent that that income is not otherwise taxed under the laws of any other jurisdiction. For this rule to apply, non-resident investors considering the entity as tax opaque would have to hold at least 50 per cent of the entity's interest. The ATAD 2 Law sets out a specific carve-out from this rule for collective investment vehicles, and alternative investment funds may also benefit from the carve-out under certain conditions (the investment fund must be widely held, hold a diversified portfolio of securities and be subject to investor-protection regulation). The 'reverse hybrid mismatches' rule may increasingly become important when choosing the corporate form and regulatory regime of new funds and will be relevant for funds investing into both European and non-European assets.

Asset managers should carefully consider the impact of the ATAD 2 Law on their existing and future fund structures as well as ATAD 2 rules existing in other EU Member States (as the rules may adversely affect the return on investments). There can be no assurance that the rules will be transposed, interpreted and applied by all EU Member States in the same or a similar manner and such differences may, in the presence of target or intermediary holding companies established in other EU Member States, lead to the application of the imported hybrid mismatches rules.

IV OUTLOOK

Brexit is likely to be one of the main challenges for the European private equity industry over the next few years. The United Kingdom left the European Union on 31 January 2020 with a transition period lasting until 31 December 2020. During this period, most EU rules will continue to apply to the United Kingdom and negotiations in relation to a trade agreement will take place. The transition period may, before 1 July 2020, be extended once, by up to two years. After the transition period, all UK fund managers will lose the benefits of EU passports, which currently allow them to manage and market their funds on a cross-border basis within the European Union. The counter-attack generally consists of establishing a regulated manager in another EU Member State. This entails building up sufficient substance locally and, in particular, recruiting suitable personnel. When comparing the solutions available in various EU jurisdictions, numerous criteria, such as the existence of a stable and robust regulatory and tax framework, must be taken into account; Luxembourg's status as the leading European fund domicile is a strong argument in its favour. Concentrating funds and their managers in one and the same jurisdiction offers many benefits: the same legal and regulatory framework, and the ability for funds and their managers to share local resources, etc. It is, therefore, no surprise that several leading private equity firms have decided to establish their European hub in Luxembourg.

Chapter 11

MEXICO

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I GENERAL OVERVIEW

Over the past 20 years, Mexico's private equity (PE) industry has raised over US$60 billion in capital commitments to PE investments, according to the Mexican Private Equity Association (AMEXCAP).[2] Mexico's strong industrial and manufacturing sectors, along with recent reforms to policies and regulations, have had a positive impact on the PE industry, resulting in double-digit annual growth for the industry.[3] Real estate and venture capital (VC) also had double-digit increases in the same period, of 11 per cent and 13.9 per cent, respectively.[4] Currently, the number of active fund managers is over 266, with fund managers, or general partners (GPs), active across a range of sectors, and representing a sevenfold growth since the beginnings of the industry in the early 2000s.

According to the Secretariat of Economy of Mexico, Mexico is one of the world's most globalised countries, with 13 free trade agreements spanning 50 countries; nine partial-scope and economic complementation agreements within the framework of the Latin-American Integration Association; membership of the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP); and 32 reciprocal promotion and protection-of-investments agreements, with 33 countries. Mexico's diversified export line is ranked 11th in the world and it is the sixth-largest car manufacturer in the world,[5] with the third-largest growth in exports within the automotive industry.[6] Mexico actively participates in multilateral and regional organisations and forums, such as the World Trade Organization, the Asia-Pacific Economic Cooperation, the Organisation for Economic Co-operation and Development and the CPTPP.

During 2020, all of the world's economies have been affected by the covid-19 pandemic and Mexico was no exception. The first case of covid-19 in Mexico was confirmed on 27 February 2020, and, because of its spread, a month later a nationwide shutdown of non-essential activities was ordered. Regardless of the effect of the pandemic, the Mexican government is optimistic as to the potential economic reactivation based on the fact that representatives of the private sector and the office of the President signed an agreement

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2 AMEXCAP, 'Private Equity in Mexico 2019'.
3 ibid.
4 ibid.
5 World Population Review: https://worldpopulationreview.com/country-rankings/car-production-by-country.
6 World Trade Organization, World Trade Statistics Review, 2018.

seeking to promote 39 infrastructure projects with a value of 297 billion Mexican pesos, with the consequent projection of recovering the lost jobs because of covid-19 by April 2021.[7] In addition, the Mexican government has been very active so as to ensure a significant amount of vaccine doses, to be delivered as soon as available by the relevant developers. The commitment of the Mexican government is to achieve an economic growth of 3.7 per cent in 2021, as forecasted by the World Bank.[8] The forecasted growth will be strengthened by the economic strategy of the Mexican government that includes a consolidation of domestic consumption as a result of the implementation of social programmes and financial inclusion, an increase of private investment in infrastructure and strategic sectors, heavier public investment, and an increase in exports as a consequence of the reconfiguration of global value chains.[9]

In recent years, the Mexican government has been an important participant in, and supporter of, the PE industry, investing in more than 72 funds[10] through institutional investors such as NAFIN (the national development bank), the Capitalization and Investment Fund for the Rural Sector, Bancomext and Banobras, and through investment vehicle Corporación Mexicana de Inversiones de Capital, SA de CV, or Fund of Funds, which has invested more than US$885 million in more than 84 funds and co-invested in 17 deals.[11] In addition, the National Institute of Entrepreneurship helped the Mexican VC industry and seed capital ecosystem by investing or co-investing in 41 funds from 2013 to 2016. For 2016, the VC support grew to 100 million Mexican pesos, targeting one fund with an approach to the Asia-Pacific alliance countries, which is now finishing its fundraising period. Finally, domestic pension funds (AFOREs) have played a determinant role in the growth of the PE industry, having allocated more than US$24.8 billion through 163 capital development certificates (CKDs) and investment project certificates (CERPIs) since 2008. This amount may increase by a further US$5.7 billion, given the CKDs that are in the pipeline.[12] Mexico is seen as one of the most favourable emerging markets to invest in, and is considered top in Latin America according to various limited partner (LP) surveys, such as those conducted by the Association for Private Capital Investment in Latin America in 2020, and by the Emerging Markets Private Equity Association in 2020.

During 2019, Mexico returned to the World Economic Forum's (WEF) list of the top 10 countries to invest in globally, by rising four positions to number nine, sitting alongside the United States, China, Germany, India, the United Kingdom, Brazil, France, Australia and Japan.[13] The Mexican economy is being reshaped, and in spite of an adverse economic environment, allows dynamism of its international trade, and the structure of its debts minimises the impact of external factors, making it a healthy option for investing. The WEF ranks Mexico in 48th place, out of 140 countries, in the 2019 edition of the competitiveness index, which shows that the country has microeconomic and macroeconomic institutions

7 *Mexican Government* (5 October 2020): https://lopezobrador.org.mx/2020/10/05/136674/.
8 *El Financiero* (5 January 2021): www.elfinanciero.com.mx/economia/economia-de-mexico-crecera-3-7-en-2021-estima-el-banco-mundial.
9 *Mexican Government* (January 2021): www.proyectosmexico.gob.mx/por-que-invertir-en-mexico/economia-solida/crecimiento-economico/.
10 Secretaria General Iberoamericana and ProMéxico, 'Informe Global LATAM: México July 2018'.
11 AMEXCAP, 'Inside Mexico's PE Market: November 2017'.
12 414 Capital, 'Instrumentos Estructurados (CKDs y CERPIs): Actualización trimestral – 3T2020' (2020).
13 WEF (18 February 2019): https://es.weforum.org/agenda/2019/02/mexico-vuelve-al-top-mundial-de-los-10-paises-para-invertir/.

with strong foundations.[14] Mexico is placed as the second-largest economy in Latin America (with an estimated GDP of US$1.222 trillion) and it is considered to have economic stability that has allowed the Mexican peso to remain stable despite various difficulties. The World Bank suggests Mexico might be the world's seventh-largest economy by 2050 – a positive outlook that will only serve to attract direct foreign investment.

Despite the uncertainty generated by the renegotiation over the past years of the United States–Mexico–Canada Agreement (USMCA), that superseded the North America Free Trade Agreement (NAFTA), it was finally signed on 30 November 2018; and the Protocol of Amendment to the USMCA, which, among other amendments, ensures that Mexican officials implement the promised labour reforms and adds changes in the agriculture sector, was agreed and signed on 10 December 2019. The USMCA finally came into effect on 1 July 2020. The USMCA, among other important changes, includes a specific chapter dedicated to boosting the growth of small and medium-sized businesses by implementing new measures such as incrementing the opportunities for commerce and investment through infrastructure development, promoting small and medium-sized businesses among minorities and start-ups, creating a committee dedicated to promoting the competitiveness and cooperation between these types of businesses and keeping entrepreneurs informed of updates and developments.[15] It also includes specialised chapters that regulate e-commerce, agriculture, labour and heavy industry (aerospace and automotive).

The PE industry and the VC sector in Mexico continue to grow and mature. The internationalisation of both funding sources and investment by domestic GPs suggests that Mexico is playing an increasingly influential role in financial and economic growth at both the regional and global levels. Within VC alone, Mexico has witnessed the number of GPs triple in the past eight years. The policies being implemented in Mexico, particularly the opening-up to competition of the energy and telecommunications sectors, and labour market reforms, have been welcome steps to attract investment and raise employment and, potentially, growth.[16] As at October 2017, an estimated US$25 billion in cash reserves were available for investment by PE funds investing in Mexico.[17]

Likewise, accumulated capital commitments from 2018 to September 2019 increased by 1.7 per cent. These capital commitments were mainly concentrated on seed and early stage VC funds.[18] As at September 2019, three new Mexican funds had been formed, bringing the number of VC funds operating in Mexico to 126, of which 60 per cent are now investing or managing their investments, while almost one-third are still at the fundraising stage.[19]

In general, information about PE funds is not publicly available during the fundraising stage unless the funds are public funds raised in the securities market, such as CKDs, CERPIs or Mexican real estate trusts (FIBRAs).

The Mexican fundraising market has been in an upward trend since 2014; as a matter of fact, 2019 was a record year in VC investments with a 60 per cent growth compared

14 *Entrepreneur* (28 January 2020): www.entrepreneur-com/article/345584.

15 *El Financiero* (19 December 2019): https://elfinanciero.com.mx/economia/tienes-una-pyme-estos-son-10-puntos-con-los-que-el-t-mec-quiere-darle-un-empujoncito-a-tu-negocio.

16 International Monetary Fund, 'World Economic Outlook: Legacies, Clouds, Uncertainties' (October 2014).

17 ibid.

18 AMEXCAP, 'Mexico: VC Overview 2019: Venture Capital Industry'.

19 ibid.

with 2018.[20] In the past, the most attractive sector has been real estate, but recently the VC sector has clearly been rising. Mexican PE funds are active, growing and covering a large spectrum of industries (business and financial services, consumer goods, healthcare, technology, oil and gas, etc.). VC funds mainly invest in consumer services, fintech and technology; real estate funds mainly target the industrial (mostly automotive, aerospace and pharmaceutical), commercial, tourism and housing sectors; and the infrastructure and energy funds are currently concentrated in the oil and gas sector. In March 2018, the Law Regulating Financial Technology Institutions (the Fintech Law) was enacted, providing for regulation of, among other things, electronic payments, cryptocurrency transactions and crowdfunding mechanisms. According to *Fintech Radar Mexico*, conducted by Finnovista in March 2020, Mexico reached the 441 fintech start-up mark, and, in 2019, it regained leadership as the largest fintech ecosystem in Latin America, in part because of a strong presence of entrepreneurship and e-commerce.[21] The Mexican fintech industry has shown an average annual growth rate of 23 per cent, with the creation of 47 new start-ups, and the dominating sectors being loans, payments and remittances.[22] Reports from recent years have highlighted the high growth rates of fintech in Latin America, such as LAVCA's *2017 Trend Watch: Latin American Venture Capital*, which concluded that the fintech sector represents 25 per cent of the venture investments in information technology in the region. According to a survey conducted by Finnovista in collaboration with Endeavor, Mexican fintech companies have a monthly gross transaction value of 39 billion Mexican pesos, with an average of 8.7 million Mexican pesos being billed per fintech start-up per year.[23] These results emphasise the importance and the possibilities of fundraising and VC investment in the development of the fintech ecosystem in Mexico. As the fintech industry represents a massive potential growth area in Mexico, the government has passed legislation that seeks to ensure financial stability and provide a defence against money laundering and corruption that proved possible to regulate the sector without imposing regulation as heavy as it is for banks.[24]

As mentioned above, Mexican VC has grown significantly, reaching US$1.794 billion in accumulated committed capital over the past 11 years.[25] Mexico's VC sector is now an attractive market in which to invest, with 75 active Mexico-based fund managers and 19 foreign GPs that performed at least one transaction in the past five years. In the same vein, AMEXCAP registered over 1,233 VC transactions for a total of US$1.5 billion invested from 2009 to September 2019 and, on the liquidity side, noted five exits during 2019. The growth seen in 2016 remains the industry record, with the largest number of transactions; however, in terms of the capital invested, the first three quarters of 2019 established an industry record with US$330 million.

In the past 20 years, foreign funds have only contributed approximately 11.2 per cent of the total accumulated capital commitments in the Mexican VC industry. However, as the number of foreign and domestic GPs increases, the activity of foreign funds is expected to increase in the Mexican VC industry.

20 AMEXCAP, 'Mexico: PE Overview 2019: Investments'.
21 Finnovista, *Fintech Radar Mexico* (May 2020).
22 ibid.
23 ibid.
24 S&P Global (7 March 2019): www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/50081755.
25 AMEXCAP, 'Mexico VC, October 2019'.

The energy reform, which ended a 70-year chapter of restrictive laws, and dismantled the state monopoly in the oil and gas and electricity sectors, has opened up investment and the participation of private and foreign companies, including PE funds, in these industries. The Federal Electricity Commission (CFE), in conjunction with the Ministry of Energy, has developed a strategy to increase gas transportation capacity through an expansion of the pipeline network to ensure gas supply for power generation. As at September 2020, there were more than 30 CKDs investing in the infrastructure and energy sectors, which have raised over 140 billion Mexican pesos.[26]

This constitutional and statutory reform continues to restructure the Mexican energy industry (some say creating it), setting out the framework for the participation of private investment not only in connection with hydrocarbons (including upstream, midstream and downstream activities) but also concerning the electricity industry, which is the sector in which the government and the private sector invest the most. The implications for Mexico's PE industry are considerable, especially now that the attention has shifted to its implementation. PE funds are able to participate in the oil industry by investing in, or lending to, companies or consortiums of companies bidding in public tenders issued by the Ministry of Energy through the National Hydrocarbons Commission, for the exploration and production of new oil fields, and the Energy Regulatory Commission, in relation to other energy matters. Considerable numbers of opportunities are starting to arise in any business relating to companies participating in midstream and downstream activities, such as petrochemicals and other transformations of hydrocarbons, and in the transportation of oil and gasoline.

Furthermore, the past three years were strong in the power infrastructure sector, starting with the completion of the first three phases of the Tres Mesas wind farm project carried out by the Spanish company Abengoa with a total investment of US$80 million and generating 593 megawatts; the inauguration of the wind farm Reynosa I, the biggest wind farm in Mexico and one of the biggest in Latin America, involving an investment of US$600 million; and seven more wind farms projects under construction.[27] In addition, Mexico is party to the Paris Agreement on climate change. As of 2020, clean energy in Mexico accounted for more than 31 per cent of the total energy produced in the country.[28]

Of the total amount of capital issued in Mexico since 2005, 75 per cent was raised between 2012 and 2017. In 2017 alone, three new funds raised a total of US$705.4 million,[29] which clearly reflects that the reforms are working and Mexico's energy sector is on the right track. We have already seen a significant increase in investment into the power sector and the gas pipelines required to fuel the new thermal power plants tendered by the CFE. International developers continue to arrive and the implementation of the reform continues to shift Mexico's energy sector in a positive direction; for example, Canadian energy firm TransCanada, in a joint venture with IENOVA and Infraestructura Marina del Golfo, was awarded a contract to construct and operate the US$2.1 billion South Texas–Tuxpan–Tula natural gas pipeline, which is now supplying natural gas from the south of Texas to Tuxpan, Veracruz, by an underwater route in the Gulf of Mexico. The South Texas–Tuxpan–Tula pipeline is supported by a 25-year transportation service agreement with Mexico's CFE, and

26 414 Capital, 'Instrumentos Estructurados (CKDs y CERPIs): Actualización trimestral – 3T2020' (2020).

27 *El Financiero* (9 August 2018): www.elfinanciero.com.mx/nacional/reynosa-i-el-parque-eolico-mas-grande-de-mexico-sera-inaugurado-el-lunes.

28 *Forbes* (17 May 2020): www.forbes.com.mx/economia-mexico-energia-renovable-sener/.

29 AMEXCAP, 'Inside Mexico's PE Market: November 2017'.

will connect with the Cenagas pipeline system in Altamira, TransCanada's Tamazunchale pipeline and Tuxpan. The South Texas–Tuxpan–Tula pipeline adds to TransCanada's portfolio, which also includes a US$550 million contract to construct a 420km gas pipeline from Tula in Hidalgo State to Villa de Reyes in San Luis Potosi. The French energy company ENGIE has invested at least US$300 million to connect its Energía Mayakan natural gas pipeline (a 485-mile pipeline that transports natural gas from Ciudad Pemex in the state of Tabasco to Valladolid in the state of Yucatan) to industrial and tourism users in the state of Quintana Roo.[30] BP expects to increase investment in everything from exploration to retail fuel sales; the British firm is already involved in three offshore projects – two in the Gulf of Mexico's deep waters and another in shallow waters. The company also launched Mexico's first foreign-branded gas station, with plans to open some 1,500 stations over five years. Tesoro Corporation (now Marathon Petroleum Corporation) reached a definitive agreement with Pemex for transportation services in Mexico. The agreement enables Tesoro to supply transportation fuels and launch the ARCO brand in the Mexican states of Sonora and Baja California.[31] In addition to the construction of the aforementioned pipelines, representing more than US$2 billion in investment, the private sector has begun to invest in storage, with the largest initiative being Orizaba Energía's investment of US$115 million to build 2.7 million barrels of capacity in Tuxpan. As at 2020, more than 110 contracts have been awarded to 73 international firms or consortiums, from 20 different countries.[32] Regarding the infrastructure sector, Mexico's federal government has committed to the promotion of its development, as well as to maintaining and improving that which already exists, thereby encouraging: a balanced regional development, a sustainable urban development and the logistic integration of the country and an improvement in its interconnectivity. Furthermore, the World Bank and the Global Infrastructure Hub highlight Mexico's capacity to prepare, procure and manage public-private partnerships. Moreover, the 'Procuring Infrastructure Public-Private Partnerships Report 2018' issued by the World Bank places Mexico as one of most prepared countries in these matters, even when compared to Organisation for Economic Co-operation and Development members, and ranks Mexico above average.[33]

Additionally, during late 2019 the Mexican government announced the first project of the new Mexico City airport, which will be operating at the current Santa Lucía military airport. Through the National Infrastructure Plan that López Obrador, the Mexican President, revealed in November 2019, the Mexican government seeks to strengthen Mexico's economy The plan implies that his government, together with the business industry, will invest a total of 859 billion Mexican pesos in infrastructure projects over the next four years.[34] The plan provides for the investment in 147 major infrastructure projects, and the money will be allocated over the next four years. Among the 72 projects that started during 2020 are (1) the expansion of the port of Dos Bocas in Tabasco; (2) the expansion and renovation of 17 airports, mainly in the south and south-east of the country; (3) the construction of the

30 ENGIE: www.engiemexico.com/#!EngieMexicoServicios/?seccion=transporte-gas-natural-ENGIE-mexico.

31 *Pemex* (18 July 2017): www.pemex.com/saladeprensa/boletines_nacionales/Paginas/2017-064-nacional.aspx.

32 Comisión Nacional de Hidrocarburos (December 2020): https://rondasmexico.gob.mx/esp/cifras-relevantes/.

33 *Mexican government* (January 2021): www.proyectosmexico.gob.mx/en/why_mexican_infrastructure/attractive-destination-for-investment-in-infrastructure/#tab-id-7.

34 *El País* (27 November 2019): https://elpais.com/economia/2019/11/26/actualidad/1574784256_745597.html.

Santa Lucía airport to serve Mexico City; and (4) the development of various roads in the Bajío region, as well as a second highway to the north of the capital. This plan is expected to positively affect the Mexican economy. During 2020, work on the Mayan Train project, that will connect a number of tourist sites around Mexico, began. Industries are changing and Mexico's global competitiveness is increasing as reforms and governmental initiatives modify the structure of the economy to attract investment. The expectation is that Mexico will become a sophisticated design and manufacturing hub rather than remain merely a low-cost producer; a clear example of this is the state of Queretaro, which is growing as a new centre for the aerospace industry, with dozens of multinationals setting up shop in the state's industry zone and making the most of generous subsidies offered by the government. At the centre of this growth is the Queretaro aerospace cluster, which is host to Safran, Airbus, GE, Aernnova Aerospace México, Duqueine Group, Delta and Bombardier, among others.[35] On the occasion of Mexico's Aerospace Summit 2019, it was announced that the aerospace industry has grown from 100 US and European producers in 2004 to more than 330 in 2019.[36] The numbers to be announced during Mexico's Aerospace Summit 2021 are expected to be higher.

The Mexican PE market has grown considerably over the past 20 years. The above-mentioned reforms, their proper implementation and a solid economic foundation are likely to foster further growth of the country's PE industry. Mexico is still viewed as one of the most attractive Latin American markets, not only because of its geographical position (sharing a border with the United States, and with access to both the Pacific and Atlantic oceans), but also because of the number of trade agreements the country has in place, making possible preferential relations with 46 countries; it also offers the benefits of a growing workforce and fiscal prudence.[37] We believe more firms will come to Mexico and reap the rewards of these favourable conditions, thereby continuing to boost PE fundraisings while profiting from the incentives arising from the newly structured legal frameworks, as was seen to be the case during 2015 and 2018.

In connection with the foregoing, in 2015 Mexico's government introduced two new investment instruments to promote the country's economic development and, in particular, to boost the PE industry. In September 2015, the creation of the first of these instruments, the FIBRA E (also known as the 'Mexican MLP'), was announced. The FIBRA E is an investment alternative in the form of an investment vehicle promoting long-term investment in Mexican-qualified energy, electricity and infrastructure assets and the management thereof, to be traded on the Mexican Stock Exchange (BMV) and offered locally and abroad. The FIBRA E allows private and public participants to monetise such assets under a tax regime that reduces levels of overall taxation and, therefore, opens the door for greater distributions. Various amendments have been made to the applicable regulations since their creation to make the instrument more appealing.

In December 2015, CERPIs were introduced. CERPIs allow insurance companies, AFOREs and other (national or foreign) institutional investors to participate in equity projects in all productive sectors of the economy. This comes as a simplified version of the existing CKD providing for a larger scope of decision by GPs and lower investment requirements for

35 www.niedersachsen-aviation.com/uploads/media/AEROCLUSTER_BROCHURE_web.pdf.

36 Mexico Aerospace Summit: www.mexicoaerospacesummit.com/.

37 Antonio Martinez Leal and Pino del Sesto, 'Private Equity in Mexico: Primed for significant growth', 16 May 2013, Bain and Company.

investors. In January 2018, certain amendments were made to the applicable regulations to allow AFOREs to acquire CERPIs that invest in portfolio companies outside Mexico (as long as at least 10 per cent of the issue amount is invested in Mexico); this particular amendment has made the instrument more appealing for issuers and AFOREs.

As to the reception by potential LPs of PE funds in the pipeline, public Mexican funds such as CKDs and FIBRAs have been favourably received by Mexican institutional investors (mainly Mexican pension funds) to the extent that the projects are adequately structured and follow the standard market terms and economics of such funds. Regarding private Mexican funds, their appeal is likely to depend on the recent success and market credibility of the sponsors or GPs of those funds. Reflecting the industry's appetite for financing new projects within the asset class, the first issuances of the relatively recently introduced FIBRA E and CERPIs took place at the end of 2016. The growth of the energy sector and amendments to the applicable regulations might well result in an increase in the issuances of these instruments.

Depending on the structure used to implement a PE fund, the time frame for PE fundraisings may vary. As an example, if the creation of a public PE fund is carried out through the issuance of CKDs, FIBRA Es or CERPIs, the time required to raise the fund may range from six to 12 months. For clarity, PE funds are generally structured as a CKD (and, as of 2016, a CERPI) to allow them to raise commitments from the AFOREs, which have very restrictive investment rules and can generally only invest in projects through these kinds of securities. Such funds are formed through Mexican trusts created to issue the CKDs or CERPIs to be placed and offered through a public offering on the Mexican stock exchanges, and managed by GPs incorporated in Mexico. Most CKDs are issued to invest in portfolio companies in Mexico subject to the investment policies determined by the sponsor. At the time of writing, over 144 CKDs have been issued to try to access a portion of the billions of dollars managed by the AFOREs that can be invested in this type of security. There are approximately 14 CKDs in the pipeline pending approval, which would capture around $65 billion Mexican pesos.[38] On average, 14 CKDs have been listed per year since 2010.

The same timeline applies for Mexican FIBRAs that raise capital through the issuance of real estate certificates, which are generally publicly offered on the BMV but can also be offered in foreign markets. The funds raised by FIBRAs can only be invested in commercial real estate projects and developments (industrial, retail and hospitality), and are structured as Mexican trusts to which real estate assets are conveyed by the original owners that, in exchange, receive real estate certificates.

The timeline for privately placed PE funds structured through Mexican or foreign vehicles will vary depending on the market conditions.

As positive evidence of the market appetite, during July 2018, a new Mexican stock exchange, the Bolsa Institucional de Valores (BIVA), began operations. The BIVA seeks to increase the operations on the Mexican market as an alternative to the BMV by easing the requirements that the latter imposes for its listings.

Below are recent deals that were made publicly available:

a in October 2020, PC Capital acquired Financiera Finsol, to strengthen its position as the largest microfinancing company in Mexico;[39]

38 414 Capital, 'Instrumentos Estructurados (CKDs y CERPIs): Actualización trimestral – 4T2020' (2020).

39 AMEXCAP (14 October 2020): https://amexcap.com/2020/10/16/pc-capital-anuncia-la-adquisicion-de-cartera-y-ciertos-activos-de-operativos-de-finsol-por-parte-de-te-creemos-holding/.

b in November 2020, G2 Momentum Capital announced its investment in KOIBANX, a fintech company, which is expected to be valued US$2.3 billion by 2021;[40]

c in December 2020, PC Capital announced its investment in Medios Cattri and the acquisition of Lightbox OOH, strengthen the position for two advertising companies in the USA and Mexico;[41]

d in December 2020, Te Creemos Holding and Banco Forjadores reached an acquisition agreement; this operation is subject to the approval of several Mexican authorities;[42] and

e in December 2020, Plataform Capital announced its commitment to invest in Angel Ventures Pacific Alliance Fund II, which is targeted to invest in early stage tech companies.[43]

II LEGAL FRAMEWORK FOR FUNDRAISING

The Canadian limited partnership has been one of the most popular legal forms for structuring PE funds with Mexican LPs' investment as they are considered transparent for tax purposes; however, certain amendments to the Mexican tax laws restrict such transparency regimes, starting in 2021. Other vehicle structures used in Mexico include the PE investment trust and the FICAP, a Mexican trust that is not considered an entity under Mexican law and that has a specific set of tax rules created to incentivise PE investments. To raise funds from investors, FICAPs issue certificates that can be either publicly placed through the BMV and more recently through the BIVA (the most recent CKDs are FICAPs) or privately issued. FICAPs are exempt from complying with certain management and tax payment obligations. The fundamental characteristic of the FICAP is that the trust is subject to a transparent regime for tax purposes, and thus the regime allows the investors to directly recognise the income generated through the trust (dividends, capital gains and interest payments) as if they had obtained the income from investing directly in a Mexican target entity. Another form that is used by PE funds is the SAPI, which is mainly a Mexican corporation that provides great flexibility to structure different kinds of businesses (including PE funds), and also increases the protection offered to minority shareholders and provides exit strategies.

The key legal and negotiable terms of PE funds will depend on the vehicle chosen, but will be very similar to those in other jurisdictions (e.g., the term of the fund, investment policies, management of the fund and documentation of the relationship between the manager and the fund, fees, carried interest and exits for limited partners).

One of the key issues for a Mexican PE fund is its management. In connection with CKD funds, for example, the sponsor will normally act as the manager, and will carry out the business of instructing the trustee to make the required investments in eligible projects; however, pursuant to Mexican securities law, it would also require the approval of the limited

40 AMEXCAP (2 November 2020): https://amexcap.com/2020/11/03/koibanx-se-suma-al-portafolio-de-g2-momentum-capital/.

41 AMEXCAP (7 December 2020): https://amexcap.com/2020/12/08/pc-capital-anuncia-inversion-en-medios-cattri-y-la-adquisicion-simultanea-de-lightbox-ooh/.

42 AMEXCAP (8 December 2020): https://amexcap.com/2020/12/09/te-creemos-holding-y-banco-forjadores-llegan-a-acuerdo-de-compraventa/.

43 AMEXCAP (31 December 2020): https://amexcap.com/2021/01/04/platform-capital-commits-to-latin-america-based-venture-capital-fund-angel-ventures-pacific-alliance-fund-ii/.

partners for relevant investments or actions, which causes the limited partners of CKDs or FIBRAs to have an active role in the management of the fund. All CKD and FIBRA investments are subject to certain guidelines (including bondholder meeting approval). Nevertheless, the structuring of CKDs has improved over time, and has evolved to the extent that CKDs are released from rules that previously prevented deals from taking place. In addition, we have noticed that management fees and carried-interest fees have changed over the past five years. The tendency has been for such fees to decrease (e.g., some CKDs had management fees amounting to around 2 per cent of the total amount invested during the investment period in 2009; currently, the management fees range between 1.5 and 1.75 per cent of the total amount invested during the investment period).

We have also noted that rather than the usual passive limited partner role, certain institutional investors are seeking a more active role in traditional PE funds.

The SAPI is governed by federal law and, more specifically, by the Securities Market Law; all items not covered by the Securities Market Law are regulated by the General Law of Business Organisations. However, the SAPI is not subject to obligations applicable to public corporations nor to supervision by the National Banking and Securities Commission (CNBV); therefore, no disclosure obligations have to be met.

PE funds are reluctant to share information because of potential threats posed by competitors and other factors. However, if the PE fund is structured through a CKD, investors and fund managers must take into consideration that CKDs are publicly listed vehicles; as such, they are obliged to disclose certain information, and their issuers have the same disclosure obligations as other debt issuers according to Mexican regulations.

Disclosure obligations include the filing of quarterly and annual reports to the BMV that include updates and annual audited financial statements, as well as a duty to disclose any information necessary for investors to carry out investment decisions.

Depending on the structure of the PE investment, the method of investment solicitation at the fundraising stage may vary.

PE funds may raise capital by privately soliciting sophisticated investors in Mexico under the Mexican safe harbour rule, which allows the offering of securities to such investors in a private placement. For public funds, such as CKDs, CERPIs or FIBRAs, solicitation is open to the general public (any kind of investor, person or entity, whether Mexican or foreign), although, generally, such funds target investments by institutional investors such as the AFOREs, insurance companies and sophisticated investors who are private banking clients. Public funds such as CKDs, CERPIs and FIBRAs are also subject to certain solicitation and publicity guidelines applicable to all issuers on the stock market.

GPs of PE funds formed as Canadian limited partnerships may be subject to certain Canadian regulations applicable to GPs.

Regarding Mexican vehicles, in structures such as SAPIs, the fiduciary duties of care and loyalty (such as conflicts of interest, disclosure and informational duties) are established contractually. Furthermore, the adoption of the Best Corporate Practices Code issued by the Mexican Business Coordinating Council and the guidelines from the Mexican Institute for Competitiveness is encouraged, and many funds have adopted these practices regarding corporate governance and fiduciary duties.

Regarding CKDs, CERPIs and FIBRAs, the manager of the fund is normally also the fund's sponsor and, in line with its responsibilities to carry out the fund's projects, it must comply with the resolutions and policies of the trust's technical committee; the committee will set up the terms and conditions of the manager's duties, and must reject any transactions that may involve a conflict of interest. Recently, it has become more common that managers of CKDs, CERPIs or FIBRAs are subject to the same fiduciary duties as directors of Mexican public companies pursuant to the federal Securities Market Law.

The FIBRA E must be structured as a Mexican trust. The applicable tax rules provide that the trust must be formed following many of the requirements applicable to FIBRAs, but with certain differences: up to 30 per cent of the trust's book value must be in federal government bonds or shares of mutual funds that may invest only in fixed income securities; and investments in shares of Mexican companies must comprise at least 70 per cent of the trust's book value. Further, those Mexican companies must comply with the following: (1) the shareholders of the company (other than the trust itself) must be Mexican resident companies (this requirement does not exclude foreign investors in any manner, and they will be entitled to own shares of the underlying company through the trust or through a Mexican subsidiary, although depending on the amount of the investment, antitrust and foreign investment approvals may be required); (2) the corporate purpose of each company must be a Mexican-qualified energy, electricity and infrastructure asset-related activity, the management thereof, or a combination of these activities, and at least 90 per cent of the annual taxable income of the FIBRA E should stem from qualified energy, electricity and infrastructure assets; and (3) the investments of the company must be in brownfield or qualified greenfield projects, as new assets may represent only 25 per cent of the book value.

III REGULATORY DEVELOPMENTS

Except for publicly placed PE funds (such as CKDs, FIBRAs, FIBRA Es and CERPIs), there is no regulatory oversight of Mexican PE funds or their fundraising processes (other than the safe harbour rule mentioned in Section II).

CKDs, FIBRAs, FIBRA Es and CERPIs are governed by the federal Securities Market Law and its ancillary regulations, and their main regulator is the CNBV. CKDs, FIBRA Es, FIBRAs and CERPIs are supervised and regulated to ensure the proper operation of the financial system and to protect the interests of the general public. In consequence, issuers are subject to quarterly and annual reporting obligations, such as presentation of audited financial statements, and the registration of the fund requires the previous authorisation of the CNBV and the BMV.

Other forms of PE funds are not under any obligation or requirement to be registered in Mexico, and the sponsors or GPs do not have to be registered in any special registry in connection with their activities as fund managers.

Depending on the legal form of the PE fund, the tax rules can vary; thus, the specific tax regime applicable to the investors may also vary. Nonetheless, generally the vehicles chosen (including limited partnerships and FICAPs) are structured in a manner that allows them to be considered tax-transparent vehicles, which implies that the income realised is directly recognised by the investors.

In the case of foreign limited partnerships, as noted above, the tax-transparency regime has been modified as of January 2021 and it is now available as a tax incentive that is expressly applicable to vehicles used to manage private equity investments in Mexican companies. Under these new rules, a foreign limited partnership may be treated as tax transparent in respect of interest income, dividends, capital gains and income from the lease of real estate properties to the extent that such partnerships are created in a country with which Mexico has a broad agreement for the exchange of information; that they do not have a legal personality of their own, separate from that of their members; that they are tax transparent in their country of formation; and that the manager file a registration with the Mexican tax authorities disclosing the identity, nature and tax residency of the investors, who should be the beneficial owners of the income and shall be subject to taxation in respect thereof. If these requirements are met, the limited partnership will be treated as being tax transparent for Mexican purposes, and thus the investors should be entitled to apply any benefits that may be included in any relevant double taxation treaty.

FICAPs, on the other hand, are also tax transparent, and are governed by a special set of tax rules that defines the withholding obligations applicable to the parties involved, as well as the moment at which the investors participating in FICAPs shall be liable to tax. More specifically, according to the rules, the investors shall be liable to Mexican tax upon receiving a distribution from the FICAP, and the tax regime actually applicable to each investor will be contingent on the nature and country of residence of the investors (e.g., institutional, foreign or local, tax-exempt or taxable).

Certain requirements under Mexican tax provisions must be met to qualify as a FICAP:

a FICAPs shall invest at least 80 per cent of the trust assets in stock issued by Mexican target entities (not publicly listed at the time of the investment) or granted as loans to such entities;
b the remaining percentage that is not invested in stock issued by Mexican target entities or granted as loans to such entities shall be invested in securities issued by the federal government or in Mexican debt mutual funds;
c the acquired stock shall be held for at least two years; and
d at least 80 per cent of the income realised by the FICAP should be distributed within two months of the end of the tax year.

If these thresholds are not reached, the trust will not qualify as a FICAP and, thus, will not benefit from the specific tax rules applicable to that vehicle.

Slight changes were made to the tax regime applicable to FICAPs in 2016; in particular, it should be highlighted that the limitation for the application of the FICAP regime for a maximum of 10 years was repealed. In the case of FIBRAs, two additional requirements were included as part of the amendments made to the income tax legislation for 2014 (and that resulted in a new Income Tax Law): (1) in the case of lease agreements where the consideration is established as a variable amount or based on a percentage, this type of income cannot exceed 5 per cent of the aggregate income of the FIBRA unless the rental payment is established as a fixed percentage of the sales of the lessee; and (2) trusts operating as FIBRAs must be registered with the tax authorities. In addition, certain measures were included in the applicable securities rules to limit the ability of FIBRAs to incur debt. And more recently, the possibility has been established for the FIBRA trust to repurchase its own certificates, subject to several conditions.

As for the FIBRA E, the main features of the tax regime that has been established may be summarised as follows:

a both the underlying Mexican companies in which the trust invests and the trust itself shall be treated as tax transparent, and the certificate holders will directly recognise the tax result of the FIBRA E as computed by the trustee under the specific rules (no monthly or annual income tax payments are required at the trust or underlying company levels);

b in computing the tax result of the trust, the trustee shall consider the tax profits generated by the underlying companies (but not the tax losses, which may only be carried forward by the entity that generated them) and a deductible deferred expense, equal to the gain generated by the seller of the shares acquired by the FIBRA E trust as per below;

c the persons selling shares to a FIBRA E will be required to recognise the gain derived from the sale of the assets owned by the company whose shares were sold (instead of recognising a capital gain on the actual sale of shares);

d the trust will be required to distribute on a yearly basis at least an amount equal to 95 per cent of its annual tax result, using the proceeds distributed by the underlying companies;

e the aforementioned distributions will not be considered dividends for tax purposes and thus the 10 per cent dividend tax will not apply;

f certain specific rules were enacted to allow the spin-off or otherwise segregate qualifying assets to special purpose vehicles in a tax-efficient manner, provided that at least a certain number of the shares in the resulting vehicle are subsequently sold to a FIBRA E within six months; and

g Mexican-resident individuals and non-resident investors will be exempt from withholding tax on the sale of the certificates issued by the FIBRA E, provided that the sale takes place through an authorised exchange.

IV OUTLOOK

The private equity industry in Mexico has been re-energised in recent years by government reforms and policies, a stable macroeconomic situation, stable population growth rate, an increase in real income and an active entrepreneurial ecosystem.

Mexico has successfully completed USMCA (which superseded NAFTA) negotiations with the United States and Canada and has gone through a smooth, peaceful and democratic power transition following the presidential election that took place in July 2018, providing certainty to investors. However, Mexico's intention of being prepared for any scenario is clear from its aim to increase trade with Argentina and the Pacific Alliance (Colombia, Peru and Chile), as well as with the European Union and Asian countries, and from the government's continued efforts over the past few years in the infrastructure and energy sectors.

While the forecasts are moderate, we expect contract and investment opportunities to be abundant as government policies support a shift towards a larger role for a combined private and public investment in the Mexican infrastructure industry and in the still-booming energy industries. Opportunities will also be presented by the continuing rise of the fintech industry and by the implementation of the governmental programme for the economic reactivation during 2021 and onwards. The outlook for the Mexican PE industry is, therefore, positive, with local funds becoming more global and deploying capital, and investments by foreign funds increasing throughout the energy sector.

We predict that the regime governing publicly issued PE funds will continue to be improved, and that the regulations regarding investment restrictions applicable to Mexican pension funds will necessarily evolve towards alignment with the types of regimes seen in other, more evolved countries, allowing the pension funds to conduct private transactions and investments in funds or projects directly (rather than only through publicly issued securities such as CKDs, FIBRAs, FIBRA Es and CERPIs).

Chapter 12

NORWAY

Peter Hammerich and Markus Heistad[1]

I GENERAL OVERVIEW

During the past 25 years, the Norwegian private equity market has matured and become more internationalised. Several factors seem to have contributed to the development of the sector. One factor has no doubt been the establishment of Argentum Fondsinvesteringer AS in 2001. Argentum is a government-owned investment company established to make private equity investments. It has committed substantial amounts in funds managed by Norwegian and Nordic managers since its inception, and had a portfolio valued at 8.3 billion Norwegian kroner at the end of 2019.[2] Another factor may have been the advent of the Alternative Investment Fund Managers Directive (AIFMD). Before this, the Norwegian private equity sector was wholly unregulated. The introduction of the AIFMD meant regulating a then unregulated sector and resulted in work towards the standardisation and institutionalisation of the actors in this sector.

The size of the Norwegian fundraising market may be viewed from the perspective of the sponsors (in terms of potential for committed capital) and from the perspective of the amount of funds raised by Norwegian sponsors.

There are no statistics concerning the size of the Norwegian market in terms of potential for committed capital. The Norwegian economy is, however, relatively small, meaning that the fundraising market is small and therefore sensitive to vintage years.

With respect to the amount of capital raised by Norwegian sponsors,[3] 2019 saw an increase compared to 2018, with 7.4 billion Norwegian kroner raised, compared to the low total of 4.5 billion the year before.[4] With the amount of funds raised in 2017 of 0.9 billion Norwegian kroner and record high fundraising in 2016, amounting to 22 billion Norwegian kroner, this illustrates the volatility between different vintage years.[5]

Notable fundraisings by Norwegian sponsors in 2020 were newcomer Equip Capital closing their first fund at €180 million (1.9 billion Norwegian kroner), as well as Norvestor's fund VIII.

The trend has been towards larger fundraisings, with firms having established their track record and a more international investor base. Further, more firms have come to market than in previous years. Although the barrier to entry for new sponsors is low from a purely

1 Peter Hammerich is a partner and Markus Heistad is a senior lawyer at BAHR.
2 Source: Argentum 2019 annual report.
3 Defined as capital raised through funds advised or managed by a firm with its head office established in Norway (Norwegian Venture Capital and Private Equity Association (NVCA)).
4 NVCA 2018 and 2019 activity report
5 NVCA 2017 and 2016 activity report.

regulatory point of view, significant fundraisings by newcomers are the exception rather than the rule. Newcomers will rarely be able to demonstrate any track record, unless they are spin-offs from previous sponsors or internal asset management departments. 2020 raised the bar for newcomers in that the guidelines on social distancing to abate covid-19 have required the use of online meetings. Institutional investors will prefer to meet new teams in person, which has been impracticable for 2020, and likely the first half of 2021. In addition, institutional investors have been wary of stretching liquidity under the pandemic, with distributions from existing private equity investments more uncertain.

The duration of fundraisings varies quite significantly, from a handful of weeks until almost a year, depending on whether the sponsor provides an offering that corresponds to investor demand at the time.

Even though 2020 has been a challenging year for business and private equity managers with more vary investors, we expect the local market to grow in the coming years, as the low interest rate climate seems set to remain for some time. Since 1 January 2019, Norwegian pension funds have been subject to new solvency rules based on a simplified version of the EU Solvency II rules, including investment freedom. This means that both Norwegian insurers and pension funds are now free to increase their allocation to private equity, where previously statutory investment restrictions held these at low levels, and perhaps lower than an optimal portfolio allocation and asset liability management should suggest.

II LEGAL FRAMEWORK FOR FUNDRAISING

Norway is a Member State of the European Economic Area (EEA). As such, the main body of legislation regulating the financial sector consists of European Union (EU) legislation transposed into Norwegian law. Management and marketing of private equity fund managers are regulated under the Norwegian Alternative Investment Fund (AIF) Act, transposing the AIFMD.

At the fund level, private equity funds are unregulated in Norway. Closed-ended funds, and open-ended funds investing in asset classes other than financial instruments and bank deposits (e.g., real property, commodities (directly, and not in derivatives)) generally fall outside the scope of the Norwegian Investment Fund Act. Although it is expected that the EU-regulated fund types European Venture Capital Funds (EuVECAs), European Social Entrepreneurship Funds (EuSEFs) and European Long-Term Investment Funds (ELTIFs) will be introduced into Norwegian law, these regulations are not yet incorporated into the EEA Agreement or implemented into Norwegian law. Consequently, legal form and key legal terms for private equity funds are primarily shaped by investor expectations and based on international market standards.

The preferred jurisdictions for the establishment of funds by Norwegian firms have traditionally been Norway for smaller funds, and the Channel Islands for larger funds by sponsors that also target non-Norwegian investors.

In terms of legal form, the preference has been for companies that are tax-transparent for the purposes of Norwegian tax law, namely limited partnerships, with a general partner having invested an amount into the partnership directly. In the past, smaller Norwegian private equity funds were also established as limited companies.

Following Brexit, several fund managers are assessing whether to move new funds to within the EEA or to establish parallel structures inside and outside the EEA. Luxembourg is likely to be the most natural jurisdiction for such funds, and some fund sponsors have made this choice for their most recent funds (e.g., Explore Equity, Norvestor VIII).

Key legal terms for private equity funds correspond to those of market standard private equity funds established as limited partnerships. Outside commercial considerations such as a team's potential for deal sourcing, prospective investors may be expected to be primarily concerned with the correlation between total fund size and management fee, risk alignment or carried interest investment by the team, key man provisions, length of investment or commitment period and of term, and conditions for extending the investment period or term. Fundraisings in the institutional market typically see extensive negotiations over key terms.

It is standard market practice and a clear investor expectation for funds to include a most-favoured-nations clause with respect to side letters. For authorised managers, this is also likely to be required under the AIF Act, as is the obligation of fair treatment of investors, whereby any preferential treatment accorded to one or more investors shall not result in an overall material disadvantage to other investors. Side letters have begun to represent a major compliance burden for managers as these bespoke demands are becoming more extensive and may often include more discretionary elements, such as environmental, social and governance (ESG) reporting. It remains to be seen whether cost-saving measures and an increased compliance burden in general will force a larger degree of standardisation and reduce the current willingness of sponsors to negotiate side-letter regulation. Coming mandatory rules for AIFMs under the EU Sustainable Finance Disclosure Regulation (SFDR) and Taxonomy regulation will work to standardise ESG disclosures and general provisions will likely replace bespoke terms in side letters on this point (see Section III.i).

Following the entry into force of the Norwegian transposition of the AIFMD, authorised managers are subject to statutory disclosure requirements to both investors and to competent authorities, both with respect to pre-investment disclosures and ongoing disclosures. Disclosures are, however, primarily market-driven, and investors typically require more extensive disclosures than those required by law alone.

The trend for increased disclosure requirements is mainly driven by institutional investors such as insurers and pension funds, which typically require more extensive ESG reporting, as well as financial reporting, making insurers capable of employing the Solvency II 'look-through' approach for calculating capital requirements. Good quality financial reporting is also required by fund-of-funds investors that have become large investors in private equity funds.

The AIF Act imposes certain requirements with respect to ongoing reporting to investors, and requires periodic reporting to the competent authorities. Institutional investors will typically have specific reporting requirements, such as insurance companies (and, going forward, Norwegian pension funds – see Section I) subject to Solvency II capital requirements, and be obliged to adopt the look-through approach to the underlying investments of a private equity fund.

Following entry into force of the AIF Act, marketing of interests in private equity funds is regulated under the AIF Act. The AIF Act and its marketing rules have had a substantial impact in the Norwegian market. While marketing of unregulated funds previously could be made without specific restrictions (other than prospectus rules, general marketing law and rules regulating investment services), the AIF Act introduced common marketing rules for all types of alternative investment funds.

The marketing rules differ depending on the jurisdiction of the manager and the fund, whether the manager is authorised or registered, and the jurisdiction of target investors.

The AIF Act and the implementation of the AIFMD in Norway are to a large extent based on a copy-out approach, with little or no 'gold-plating'. Norway has implemented the AIFMD thresholds, allowing for light-touch regulation of managers of smaller funds that are not mutual funds (in simple terms, less than €500 million for closed-ended funds and less than €100 million for open-ended funds).

For private equity managers, that threshold will typically be €500 million, as funds as a rule are unleveraged at the fund level. In practice, the authorisation requirement will be triggered by the fact that the manager wishes to manage a fund established outside Norway, or to market fund interests to investors that are not professional according to the definition in the AIFMD. Norwegian rules concerning marketing of interests in AIFs to non-professional investors require that the manager is authorised under the AIFMD.

Whether or not the fund sponsor corresponds to the fund manager (on which the onus of regulation of the AIFMD lies) will vary depending on how the fund structure has been organised. Norwegian private equity funds will typically be managed by an external manager that is either registered or authorised. Internally managed private equity funds are rare. Certain larger sponsors with funds established outside Norway and the EEA, typically the Channel Islands, may have a structure where the manager (typically the general partner) is also established in the Channel Islands, and any Norwegian entities operate in an advisory function to the general partner. Advice in the context of private equity funds has been viewed by the Financial Supervisory Authority of Norway (FSAN) as being outside the scope of investment advice as defined in the Markets in Financial Instruments Directive (MiFID II). This mode of organisation requires that the actual management of the fund is undertaken outside Norway, and that the advisory company does not engage in investment advice or any other regulated activities.

Marketing of Norwegian unregulated funds by managers falling below the threshold values of the AIFMD and established in Norway are not subject to the specific marketing notification rules under the AIF Act. Managers of sub-threshold funds may opt in to benefit from the marketing passport under the AIFMD.

Norway has implemented the private-placement provisions of the AIFMD with respect to funds and managers established outside the EEA. On this point, however, the rules are somewhat more strict than under the AIFMD, as they require prior authorisation from the FSAN to market, rather than relying on notification only. In addition, for fund managers established outside the EEA, there is a requirement that they are registered with a competent authority and subject to prudential supervision in their home state for the purposes of asset management. With the entry into force of Brexit, the FSAN offered a fast-track re-registration for UK AIFMs having passported or availed themselves of the private placement rules.

If the interests issued by unregulated investment funds are financial instruments, then services related to those interests (such as arrangement services or second-hand share sales) constitute investment services that fall within the scope of MiFID II, transposed into Norwegian law through the Securities Trading Act (the ST Act). Under Norwegian law, interests in limited partnerships are generally not viewed as financial instruments, but there is a specific extension of the scope of the ST Act to include interests in limited partnerships where those interests represent a commitment of less than 5 million Norwegian kroner or the investors are not professional investors per se according to the definition in MiFID II.

In addition, the offer of interests that are financial instruments may trigger a requirement to publish a prospectus under the public offering rules of the ST Act, unless an appropriate exemption is available.

Marketing of private equity funds to non-professional investors requires a separate authorisation by the FSAN, and is only available to funds managed by an EEA-authorised alternative investment fund manager (AIFM).

There have been few supervisory actions in the private equity segment, largely because the majority of funds have targeted institutional and professional investors. The FSAN has primarily focused on monitoring marketing activities by sub-threshold managers in respect of non-professional investors, and selling practices in respect of shares in investment companies for real estate investments. With respect to reverse solicitation, the FSAN will typically require firm documentation for reverse solicitation to substantiate that no marketing has been undertaken with respect to non-professional investors without authorisation.

The scope of fiduciary duties that a fund manager owes to the fund investors is different for authorised AIFMs and for registered AIFMs.

Authorised AIFMs are subject to overarching business-conduct rules, as further specified in the AIF Act and the AIFM delegated regulation. Registered AIFMs are only subject to contractual obligations towards fund investors, and general marketing and contract law.

Authorised AIFMs are required to appoint a single depository to each fund under management. This includes unregulated funds not previously subject to such a requirement. Although there are a limited number of available Norwegian service providers in this segment, this has not proven to be a bottleneck for the establishment of new funds. However, the FSAN has proved sceptical of depositaries in the same group as the AIFM. Further, authorised AIFMs are subject to specific requirements concerning internal organisation, including separation of risk management, and valuation and compliance functions, as well as rules limiting their activities to managing alternative investment funds and certain MiFID investment services as ancillary activities subject to prior authorisation. Authorised AIFMs may therefore also offer managed account products provided that the AIFM has the relevant authorisation.

III REGULATORY DEVELOPMENTS

i Regulatory oversight and registration obligations

Following the transposition of the AIFMD into Norwegian law, private equity fund managers and their activity fall under the oversight of the FSAN. Pursuant to the AIF Act, the FSAN is responsible for the oversight of managers – including both registered and authorised managers – and indirectly the funds managed by such managers. The Consumer Authority has oversight of actors in the financial sector providing services to consumers, including investment products such as private equity fund interests offered to consumers, and the marketing of such products and services.

The EU Packaged Retail and Insurance-based Investment Products Regulation (the PRIIPs Regulation), which has a requirement for a key information document (KID) when making interests in private equity funds available to non-professional investors, has not been implemented in Norwegian law. Instead, there are non-EEA-based rules requiring a

KID to be drawn up to obtain authorisation to market AIFs to non-professional investors. For asset managers active in the retail markets, the impact of the PRIIPs Regulation may introduce increased competition and cost transparency. Higher costs and risks connected to retail products may also lead to reduced competition, if non-Norwegian sponsors do not find the market large enough to warrant the investment. Distribution of private equity interests in the retail segment is also be affected by MiFID II and stronger investor protection rules. The new rules on inducements under MiFID II may affect sponsors in terms of how they can distribute funds in a cost-effective manner. It remains to be seen whether the increased transparency offered by PRIIPs will also affect the marketability of different segment (and higher-cost) funds in the retail markets, and whether this transparency will also affect the approach of institutional investors, especially smaller institutional investors that are not large enough to directly influence costs of management.

The coming year will see the entry into force of statutory ESG reporting and disclosure requirements for AIFMs. The EU SFDR and Taxonomy regulations will not have direct effect in Norway, but must be implemented into local law. The Norwegian Ministry of Finance and the FSAN is focused on avoiding adverse effects of 'greenwashing' in the financial markets and have put forward proposals for a law to implement the regulations possibly before they are incorporated into the EEA Agreement. Although the rules do not – as a starting point – contain substantive investment restrictions, the spirit of the rules and the seeming appetite for ESG and sustainability products from institutional investors would likely require private equity fund managers to integrate ESG into their investment and risk management processes to a much higher degree than has been the case to date.

As mentioned above, private equity funds are not regulated at the fund level in Norway. The EU regulations concerning the EuVECA, EuSEF and ELTIF regulated fund types have not been incorporated into the EEA Agreement or implemented into Norwegian law. There are therefore no specific regulatory requirements concerning the funds themselves. However, the rules of the AIF Act, which apply to fund managers, require that the funds are registered with the FSAN as being managed by the manager, irrespective of whether the manager is a registered or authorised AIFM. Further, certain provisions of the AIF Act, such as those concerning valuation, will have some bearing on the terms of the fund. In June 2019, the FSAN issued a circular concerning project finance companies and the scope of the AIF Act. Project finance companies that are single asset funds have been widely distributed in both the professional and retail spaces, as it has been the market view that these were outside the scope of the AIF Act. Pursuant to the FSAN circular, the FSAN holds that most such undertakings constitute AIFs subject to the AIF Act, unless they are joint ventures or the investors otherwise have day-to-day discretion or control.

Registered and authorised AIFMs are equally subject to the Norwegian anti-money laundering act (transposing the EU Fourth Anti-Money Laundering Directive into Norwegian law) and the General Data Protection Regulation (GDPR), as well as to requirements under tax reporting legislation implementing the Foreign Account Tax Compliance Act (FATCA) and the Organisation for Economic Co-operation and Development Common Reporting Standard (CRS).

ii Taxation of Norwegian funds and investors

With respect to taxation of Norwegian private equity funds and investors, Norwegian taxation broadly depends on whether a Norwegian fund is transparent (typically a limited partnership) or opaque (typically a limited liability company) for Norwegian tax purposes.

iii Taxation of transparent Norwegian funds and their investors

A transparent fund is not subject to Norwegian taxation. Instead, the income, gains, costs and losses of the fund are calculated at the level of the fund and taxed at the hands of its investors on a current basis (irrespective of whether the fund makes any distributions).

An investor (Norwegian or foreign) is taxable for its share of the fund's net income and gains at the ordinary tax rate of 22 per cent (25 per cent if the investor is subject to the financial tax rate; see Section III.vi). However, any gains deriving from the fund's qualifying equity investments (see Section III.v) are tax-exempt, while any dividends from such investments are subject to effective taxation (3 per cent of dividends taxable at the ordinary tax rate) of 0.66 per cent (0.75 per cent if the investor is subject to the financial tax rate).

An individual investor is further subject to an effective tax rate of 31.68 per cent on distributions from the fund to the extent they are not treated as tax-free repayments of paid-in capital, as well as on gains upon disposal of interests in the fund. The individual investor is, however, allowed a deduction in the distributions or gains for any taxes paid by the investor on the income and gains of the fund, and is further allowed a minor shielding deduction.

A corporate investor is subject to 0.66 (0.75) per cent effective taxation on distributions from the fund (3 per cent of distributions taxable at the ordinary tax rate), to the extent they are not tax-free repayments of paid-in capital. The corporate investor is tax-exempt on any gain upon disposal of interests in the fund, provided at least 90 per cent of all equity investments held by the fund have been qualifying equity investments (see Section III.v) for a consecutive period of at least two years immediately prior to the investor's disposal. Otherwise, the gain would be subject to the ordinary tax rate of 22 (25) per cent.

An investor may generally deduct costs, although a corporate investor may not deduct acquisition or realisation costs related to qualifying equity investments. Losses are generally deductible to the extent corresponding gains would be taxable, but with certain limitations that are not dealt with further in this chapter.

The above generally applies to both Norwegian and foreign investors, but the foreign investors may, for example, be exempt from Norwegian taxation under an applicable double-tax treaty, and certain other deviations may apply.

iv Taxation of opaque Norwegian funds and their investors

An opaque fund in the form of a limited liability company is subject to the ordinary tax rate of 22 per cent on its income and gains. The rate is 25 per cent if subject to the financial tax rate (see Section III.vi). However, any gains deriving from the fund's qualifying equity investments (see Section III.v) are tax-exempt, while any dividends from such investments are subject to effective taxation (3 per cent of dividends taxable at the ordinary tax rate) of 0.66 per cent (0.75 per cent if the investor is subject to the financial tax rate). Such dividends are fully exempt from taxation if they are paid by an EU or EEA-resident company in which the fund holds more than 90 per cent of both share capital and votes (subject to certain conditions). The fund may generally deduct costs to the extent that they are not acquisition or realisation costs related to qualifying equity investments. Losses are generally deductible to the extent that corresponding gains would be taxable, but with certain limitations that are not dealt with further in this chapter.

A Norwegian individual investor is subject to an effective tax rate of 31.68 per cent, minus a minor shielding deduction, on gains and dividends from the fund, and is entitled to deductions for associated costs and losses.

A Norwegian corporate investor is tax-exempt on any gains from the fund and is subject to effective taxation (3 per cent of dividends taxable at the ordinary tax rate) of 0.66 (0.75) per cent on any dividends from the fund. Correspondingly, losses are not deductible.

A foreign investor is in general subject to 25 per cent Norwegian withholding tax on dividends from the fund, while any gain upon disposal of interests in the fund is not subject to Norwegian taxation unless the shares are connected to a permanent establishment maintained by the foreign investor in Norway. The foreign investor may be entitled to a reduced withholding tax rate under an applicable double-tax treaty. Foreign corporate investors that are genuinely established and carrying on genuine economic activities within the EEA are normally exempt from withholding tax. Further, individual investors resident within the EEA may claim a reduced withholding tax if the withholding tax exceeds the net taxation that would have been borne by a Norwegian individual investor.

v Qualifying equity investments

Norway has a tax-exemption method that applies to qualifying equity investments. Qualifying equity investments include (1) shares in Norwegian limited liability companies and similar opaque entities, (2) shares in corresponding EEA limited liability companies, provided the EEA company in question is not a wholly artificial arrangement established in a low-tax country, and (3) shares in corresponding non-EEA limited liability companies, provided the non-EEA company is not resident in a low-tax country, and further provided the fund holds at least 10 per cent of the share capital and votes of the non-EEA company for at least two consecutive years. Qualifying equity investments further include investments in tax-transparent entities, provided that at least 90 per cent of all equity investments held by the transparent entity have been qualifying equity investments for a consecutive period of at least two years.

vi Financial tax rate

Since income year 2017, a specific finance tax has applied to Norwegian asset managers (and Norwegian branches of foreign asset managers). The tax is composed of two elements; a 5 per cent tax on the aggregate payroll expenses and a 25 per cent tax on net income (compared to 22 per cent, which is the ordinary tax rate for 2021).

vii Carried interest

For funds sponsored by Norwegian managers, the right to carried interest normally depends upon the investors having received payment for the entire contributed amount, in addition to a minimum return (typically 8 per cent). The excess proceeds are normally divided (usually 80:20) between the investors and those who have the right to carried interest.

The year 2013 saw the first court case on taxation of carried interest, involving the management company Herkules Capital and three partners. The case concerned the validity of a reassessment of income for 2007 by the tax authorities against Herkules Capital and the three partners, who had received amounts under carried interest. The tax authorities had concluded that the amounts – which had accrued to the partners' personal wholly owned investment companies – constituted ordinary income (salary) for the relevant persons, and that the amounts received by the general partner were taxable as business income in the hands of Herkules Capital.

After an annulment of the tax authorities' reclassification in the court of first instance (district court) and a full win for the tax authorities in the court of appeal, the Supreme Court rendered its judgment on 12 November 2015. The Supreme Court found that the amount of carried interest received by the partners' investment companies was not taxable as ordinary income (salary) for those persons. Further, the court found that the part of the carried interest amount received by the general partner corresponding to the partners' share could not be reallocated to Hercules Capital as business income. In coming to its conclusion, the Supreme Court emphasised that the taxation of carried interest must be based on the agreed allocation of income between the parties (unless the agreed allocation constitutes a tax avoidance in breach of the general anti-abuse rule or is not based on the arm's-length principle). Further, the Supreme Court emphasised that even though the contribution by the partners was an important factor for the achievement of carried interest, carried interest was also a result of other factors, such as the persons working in the relevant portfolio companies and market developments.

IV OUTLOOK

The Norwegian private equity sector has gone through significant changes between 2014 and the present. In 2014, the AIFMD was transposed into Norwegian law. Before that, both management and marketing of private equity funds were unregulated. Compliance practices were purely market-driven. On the other hand, the Norwegian investor market was also restricted in that both insurance companies and pension funds were strictly limited in their allocation to private equity investments. These restrictions have now been repealed following the transposition of Solvency II for insurance companies, with similar rules for Norwegian pension funds. Combined with the institutionalisation of the sector under regulation and the low interest rate climate, this may provide continued growth of private equity as an asset class.

The introduction of the AIFMD could be seen as the starting point for a more intensive regulation of the sector. Following the introduction of the AIFMD, Norwegian fund managers have also been subject to the Norwegian implementation of the EU anti-money laundering directive, FATCA/CRS and the GDPR. Further, investors have become increasingly affected by managers establishing robust ESG policies for their investment activities. Insurers, pension funds and funds-of-funds are drivers behind this development, and managers are increasingly required to meet new ESG diligence and reporting requirements, as well as changing the interaction with portfolio companies to take into account 'non-economic' factors.

Outside market developments, there are three important challenges going forward for the Norwegian private equity sector. First, both in time and likely importance, Brexit may reduce market access for Norwegian fund managers to the UK market, as well as reducing the overall fundraising capability of placement agents currently headquartered in the City. We expect the market to adapt quite quickly, but the outcome is difficult to foresee.

Second, the Norwegian financial sector – and indirectly the investors and clients, both Norwegian and foreign – have been affected by the long and seemingly growing delay in implementing EU financial legislation in Norway. After the entry into force of the EEA Agreement in 1994, Norway generally implemented EU legislation with great assiduity. This changed following the establishment of the EU system of financial supervision in 2011 and the increasing legislative activity of the EU following the financial crisis.

The EU supervisory organisations – the European Banking Authority, the European Securities and Markets Authority, and the European Insurance and Occupational Pensions Authority – have partially supranational authority, and this conflicts with the principle of the EEA Agreement, whereby no sovereignty shall be relinquished by the EEA Member States. An agreement concerning the incorporation of the EU regulations establishing the European Supervisory Authorities into the EEA Agreement and integration into the EU system of financial supervision was concluded on 14 October 2014[6] and approved by the Norwegian parliament in June 2016. This led to a delay in implementation of EU law passed during that time. Further, it seems the legal mechanism of the relevant agreement concerning financial supervision is labour intensive, whereas the number of legal acts and delegated legal acts adopted in the EU is inflating, even with the respite afforded on this point by Brexit diverting resources within the EU. The backlog of outstanding legislation does not seem to decrease in any significant way and it is difficult to see any clear prioritisation other than capital requirements.

In the asset management area, the regulations concerning EuVECA, EuSEF and ELTIF funds have not yet been implemented in Norway. Although these fund types do not seem to have had any resounding success in other EU countries, they may provide specific advantages under Norwegian law, as providing loans is a regulated activity in Norway. These fund types could, therefore, provide managers with greater flexibility and market opportunities in their investment activity in the unlisted markets in Norway. On 15 January 2018, the Ministry of Finance initiated a public consultation on the implementation of amendments to EU EuVECAs and EuSEFs and the delegated regulation under the ELTIF Regulation. None of the main regulations have entered into effect in Norway yet, and these will require an amendment to the Financial Undertakings Act to allow these funds to provide loans.

Lastly, the review of the AIFMD is expected later in 2020, after having been delayed because of Brexit. Legal reform brings an element of uncertainty. It is to be expected that Brexit and the position of third countries under the rules will affect the review. Private equity managers that have established or plan to establish funds in the Channel Islands, for example, would be sensitive to changes in this respect.

6 www.efta.int/about-efta/news/eea-efta-and-eu-ministers-reach-agreement-european-supervisory-authorities-3211.

Chapter 13

PORTUGAL

André Luiz Gomes, Catarina Correia da Silva and Vera Figueiredo[1]

I GENERAL OVERVIEW

Fundraising activity in Portugal has been increasing, although slowly. There was an increase in the number of active private equity funds and in the amount of assets under management.

According to the information available on the website of the Portuguese Securities Market Commission (CMVM),[2] there are currently 171 private equity funds and 55 private equity companies.

The assets under management in the Portuguese private equity sector in 2019 increased to around €5.1 billion representing a 6.6 per cent growth,[3] maintaining the growth trend observed in previous years.

The increase of the number of private equity funds was mainly due, in recent years, to the implementation by the Portuguese Government of the SIFIDE II. SIFIDE II is a research and development (R&D) public incentive scheme whereby companies can save corporate taxes by investing in private equity funds that then invest in Portuguese target companies to fund their R&D projects, aiming to increase the competitiveness of companies by supporting their R&D efforts.

A trend that has also been observed in recent years is the setting up of private equity funds aimed at attracting investment from those wishing to apply for Portugal's Golden Visa. Private equity funds that fulfil some legal requirements (e.g., minimum investment amount; investment policy) listed by the Portuguese Regulatory Authority, become qualified for this type of investment. This trend may in part explain the growth of non-resident participants (from 17.5 per cent in 2018 to 23 per cent in 2019) and the fact that the majority of non-resident participants are private individuals.

Although there is a high number of private equity investment vehicles (mainly private equity funds), the assets under management are concentrated in a short number of private equity funds: 11 private equity funds with assets under management greater than €100 million concentrated around 54.7 per cent of the total, while funds with assets under management less than €20 million represented 12.5 per cent of the total.[4]

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2 Information from the CMVM website: https://web3.cmvm.pt/sdi/capitalrisco/pesquisa_nome_fcr.cfm.
3 CMVM Annual Report of Private Equity Activity 2019, page 7
4 ibid.

This data demonstrates that private equity funds are the preferred investment vehicles used in the Portuguese private equity industry, with private equity companies predominantly assuming the role of management companies of the private equity funds rather than investment vehicles with their own portfolio.

The aggregate level of private equity activity in Portugal has generally been low compared to the European averages in all three stages: fundraising, investment and divestment.[5]

In Portugal, banks have significant weight as investors while the participation of traditional institutional investors is less significant, as opposed to other advanced markets, where traditional institutional investors and retail investors play an insignificant role compared to banks as investors in private equity.

Private equity activity analysed by investment stages shows that investment activity in turnaround operations (including strategic reorientation and company recovery operations) decreased 13.3 per cent at the end of 2019, while expansion operations increased 2.9 per cent, 'shareholder restructuring' increased 58.6 per cent to €316.2 million and venture capital increased 10.5 per cent.[6]

When comparing investment stage with European data, Portugal still has a strong bias towards turnaround (28.8 per cent versus 0.2 per cent in Europe), followed by expansion (22.9 per cent versus 17.2 per cent) and management buy-out (17.4 per cent versus 69.2 per cent). In contrast, the venture capital stage (seed capital, start-up and early stage) continues to represent a small share of the total private equity investment.[7]

According to a recent OECD survey,[8] in Portugal, the size of both fundraising and investment activities in the private capital markets are well below the European averages, and the private equity market in general appears to be less developed.

Another distinction between Portugal and other European peer countries is related to the average fund size. In Portugal, the average fund is €39.2 million, whereas the European average is €68 million.[9]

Small fund size can be an impediment for private equity firms to grow as it is more difficult for smaller funds to achieve economies of scale and to diversify properly, which can drag down profitability.

Regarding the duration that a fundraising process can take, although there is no official data on that, according to the authors' recent experience, it may take six to 18 months.

II LEGAL FRAMEWORK FOR FUNDRAISING

Private equity activity is primarily governed by Law No. 18/2015 of 4 March 2015, as amended (the Law).[10]

5 OECD Capital Market Review of Portugal 2020, page 58.
6 CMVM Annual Report of Private Equity Activity 2019, page 17.
7 id., page 17.
8 OECD capital Market Review of Portugal 2020, page 58.
9 id., page 59.
10 The Law changed the legal framework applicable to private equity activity transposing into the Portuguese legal framework the Alternative Investment Fund Managers Directive (AIFMD).

According to the Law, private equity activity consists in the investment in target companies (either through equity or debt capitalisation instruments) with a high potential for development and growth, to benefit in the future from this growth and development through the future sale of those target companies.

There is no accurate distinction in Portugal between the concepts of private equity and venture capital, with these concepts being used interchangeably. Therefore, unless stated otherwise, the term 'private equity' in this chapter refers to private equity activity in a broader sense, comprising private equity activity in all its forms, including venture capital.

The Law sets out two different legal regimes:

a a legal regime for those management entities whose value of assets under management falls within the following thresholds (i.e., that fall within the scope of the AIFMD): greater than €100 million, when the corresponding assets were acquired through the use of leverage, or of more than €500 million in unleveraged assets that do not grant investors redemption rights for an initial five-year period; and

b a legal regime for those management entities whose assets under management do not fall within the AIFMD thresholds, which reproduces the legal framework previously in force as set out in the former decree law, although with some amendments.

The legal regime referred to above at (b) is less stringent than that at (a), as the provisions of the Law, with a view to protecting investors, set out tighter requirements regarding (1) authorisation and registration of management entities with the supervising authorities; (2) internal organisation; (3) conflicts of interest to be avoided, managed or disclosed; (4) risk management policies; (5) valuation rules; (6) remuneration policies; and (7) delegation and sub-delegation of functions to third parties.

However, the managing entities referred to above at (b) may opt to request authorisation to carry out activity as a managing entity above the AIFMD threshold (opt-in procedure) and be subject to the stricter legal framework but also able to benefit from the rights granted under the AIFMD (e.g., applicability of the EU Passport).

i Preferred jurisdictions for funds

As regards investors' preferred choice of jurisdiction, in the authors' experience, Portuguese investors tend to select Portuguese private equity investment vehicles whenever the investment target is located primarily in Portugal.

As referred above, the private equity funds qualified to Portugal's Golden Visa and the public incentive scheme (SIFIDE II) that seeks to support Portuguese companies in R&D continues to contribute for the increase of the number of private equity funds in Portugal.

As a matter of fact, according to the available data, most of the investors (77 per cent in 2019) were Portuguese residents, although there is a decrease compared to the previous year (82.5 per cent in 2018), among whom the legal persons stand out. In contrast, when we consider non-residents, the majority are individual investors.

ii Legal forms of private equity vehicles

The Law provides for different regulated private equity vehicles, depending on whether they fall within or outside the scope of the AIFMD, and these are outlined below, being the private equity companies and private equity funds that are the main vehicles used.

However, as noted above, the dynamic activity of private equity in recent years has been mainly supported by the growth of private equity funds rather than by private equity companies.

Private equity vehicles outside the scope of the AIFMD

Private equity companies

Private equity companies[11] are limited liability companies[12] incorporated with a minimum share capital of €125,000. Note that private equity companies are vehicles that:

a can be incorporated to directly own a portfolio of investments;

b can be incorporated with the sole purpose of managing private equity funds; or

c can combine both activities (i.e., they can directly own a portfolio of investments and manage private equity funds).

In practice, private equity companies predominantly assume the role of management companies of the private equity funds rather than investment vehicles with their own portfolio.

Private equity funds

Private equity funds[13] are contractual funds managed by entities that do not surpass the thresholds set in the AIFMD: autonomous sets of assets without legal personality. Private equity funds are not responsible whatsoever for the debts of the investors, or for the debt of the entities that undertake the fund's management, deposits and marketing, or for the debts of other private equity funds. This legal form corresponds to the more commonly known 'contractual funds'. Private equity funds have a minimum subscribed capital of €1 million.

Private equity investors

Private equity investors are special private equity companies mandatorily incorporated as a sole shareholder limited company, and only individuals could be the sole shareholder. The registration of private equity investors with the CMVM is not made public.

Private equity vehicles within the scope of the AIFMD

Private equity fund management companies

Private equity fund management companies[14] are limited liability companies, incorporated with a minimum share capital of €125,000, whose scope is the management of private equity funds that fall within the scope of the AIFMD and are not allowed to directly own a portfolio investment. Following that, these companies are subject to more demanding legal requirements, namely as regards the authorisation and registration procedure and operating rules.

11 *Sociedades de capital de risco.*

12 *Sociedades anónimas.*

13 *Fundos de capital de risco.*

14 *Sociedades gestoras de fundos de capital de risco.*

Private equity investment companies

Private equity investment companies[15] are funds of a corporate nature whose purpose is direct investment in private equity, and in having their own portfolio. These companies may be externally or self-managed. If externally managed, they are managed by private equity fund management companies or by collective investment undertakings management companies. If self-managed they must have a minimum share capital of €300,000.

Private equity collective investment undertakings

Private equity collective investment undertakings[16] are contractual funds managed by entities above the threshold set in the AIFMD; namely, private equity fund management companies or collective investment undertakings management companies. The legal provisions concerning the above-mentioned private equity funds that fall outside the scope of the AIFMD are also applicable to these funds, along with more specific and demanding provisions regarding liquidity management, asset evaluation and disclosure of information to the investors and to the CMVM.

iii Key legal terms

The relationship between investors and the private equity vehicles (i.e, the functioning and operating rules of the private equity funds) is also governed by a set of rules negotiated with the investors, which in addition to the applicable legal and regulatory provisions will constitute the fund's rules as the fund's primary constitutive documentation.

Certain legal terms are imposed by mandatory provisions set out in the Law (to be provided in the private equity fund's rules) and others that, although not mandatory, are typically negotiated between the investors and the private equity management entities.

The following typical key terms are worth highlighting:

a key-man provisions: these are applicable to certain key members of the private equity fund's management company, who are expected to devote their business time to the management of the private equity fund or the private equity company concerned; should this not be the case, several consequences may be triggered, such as the replacement of those key members or the immediate suspension of new investments, follow-on investments or divestments for which there were no binding commitments prior to the event;

b borrowing limits of the private equity fund: according to the Law, the borrowing limits shall be set out in the fund's rules. This is an important item decided between the investors and the management entities;

c portfolio diversification: provisions that impose investment diversification criteria more stringent than those imposed by the Law;

d investment restrictions: geographic limitations, and limitations regarding the type of industry (e.g., prohibited industry sectors);

e removal of the fund's management company: provisions regarding the removal of the fund's management company either with or without cause. Typically, 'cause' will include fraud, wilful misconduct, gross negligence, material breach of the fund's legal documentation, or any unauthorised change of control. As cause may be difficult to

15 *Sociedades de investimento em capital de risco.*

16 *Organismos de investimento em capital de risco.*

prove, the negotiations tend to focus on the relevant terms that will trigger removal 'without cause', notably regarding relevant voting majorities, implications for management fees and the right of the management entity to eventual compensation;

f exclusivity: provisions regulating the setting up of other funds by the managing entities;

g early termination: provisions allowing for the early termination of the investment period (this is an investor protection provision). This is one of the negotiable terms that has given rise to more detailed provisions;

h LP advisory committee: an advisory board composed of nominees of the investors. Their typical functions are the monitoring of conflicts of interest and taking relevant resolutions on these matters;

i change of control: provisions aiming to prevent change of control in the management entities, establishing that, in the event of an unauthorised change, an early termination of the fund may occur, or replacement of the management entities; and

j classes of participation units: creation of different classes of participation units to adapt the market to different investors' profiles, aiming also to promote the investment of retail investors. The different classes of units have different characteristics, notably, regarding the timing of the realisation of capital, subscription conditions and distribution of income.

iv Key disclosure items

The information to be provided to the investors on an ongoing basis is usually regulated by the fund rules, which usually stipulate that the information shall be reported quarterly. These reports usually contain consolidated information on variations in the net asset value, an overview of each of the key figures in the portfolio companies, and market comparisons.

Note that the Law, following the AIFMD provisions, sets out more onerous disclosure requirements that must be made to investors before they invest in private equity activity; namely, regarding the investment strategy and objectives, leverage, how changes in strategy may be implemented, service providers, valuation procedures, fees and expenses, risk profile, remuneration practices and policies, and a historical outline of the financial results obtained by the private equity fund.

Private equity entities shall submit information to the CMVM, notably regarding investment portfolios, capital, performance, commissions, investors, the acquisition and disposal of assets, and the balance sheet and financial statements,[17] as well as regarding main risk positions, most important concentrations of risk, total value of assets under management, and a general description of the investment strategy.

The provision of this information is integral to the CMVM's supervisory function and important for statistical purposes.

v Solicitation of investors

Most commonly, solicitation is made by way of initial contact with the key investors, which is followed by a distribution of the draft of the fund rules that will govern the private equity fund. The fund rules are the primary constitutive document to be negotiated with the potential investors.

17 CMVM Regulation No. 3/2015 (amended by CMVM Regulation No. 5/2020).

As a matter of fact, the Law expressly states that the subscription or acquisition of a private equity fund's investment units is conditional upon being subject to that fund's rules. As such, whenever there is a subscription, the investor must at the same time accept and agree to be subject to the fund's rules.

Where the vehicle is a private equity fund (whether of a corporate or a contractual nature), a solicitation process by private subscription includes the negotiation of the fund's rules and, in the case of a vehicle of a corporate nature, also the negotiation of the articles of association between the investors and the fund's management entity. Similarly, a solicitation process by public offer entails the negotiation of the prospectus.

Portugal has been witnessing a recourse to international placement management to allow access to international LPs.

If the solicitation is made by public offer, the general rules set out in the Portuguese Securities Code apply. However, in Portugal, typically fundraising in private equity does not involve a public offer.

vi Fiduciary duties of management entities

When performing their management activities, the directors of management entities shall comply with the fundamental fiduciary duties set out in the applicable company law – the Portuguese Companies Code – which include the duty of care and the duty of loyalty. Portuguese law defines the duty of care standards to be observed by directors as that of a wise and orderly manager, with an understanding of the company's business appropriate to their role. In addition, directors must have the availability and the proper technical capacity and skills to perform their relevant functions.

Furthermore, the duty of loyalty includes an obligation to act in the best interests of the company and to consider the long-term interests of the shareholders, as well as those of the company's stakeholders who are relevant for the company's sustainability. Additionally, this duty entails a non-competition obligation towards the company, which requires directors to place the interest of the company and its shareholders above their own.

The Law particularises the following duties for management entities:

a to refrain from entering into arrangements that may lead to a clash of interests with investors;

b to set an organisational structure and internal procedures proportional to the size and complexity of their activity;

c to perform their activities to safeguard the legitimate interests of the investors; and

d the board members of these entities must be reputable and experienced, to ensure sound and prudent management.

Moreover, in many cases the fiduciary duties are expressly set out in the constitutive documents (e.g., the fund's rules), thereby ensuring higher standards.

III REGULATORY DEVELOPMENTS

i Regulatory oversight by the national authorities

The prudential and market conduct of the above-mentioned private equity vehicles are subject to the CMVM's supervision.

Pursuant to the aforementioned powers of supervision granted to it, the CMVM has decision-making powers regarding the granting, or refusal, of registry or authorisation, as applicable, as well as powers to demand of private equity management entities the provision of all necessary information or documents for compliance with the legal framework of private equity activity and to impose fines and penalties.

Investors are not necessarily subject to CMVM supervision simply because they are private equity investors. In fact, an investor may be subject to supervision by any national authority as a result of its functions, but not merely as a result of being a private equity investor (e.g., if the investor is a bank or any other credit institution, it is subject to the supervision of the Bank of Portugal).

However, the Law provides that holders of qualifying holdings in all private equity companies should comply with the conditions that ensure the sound and prudent management of those companies.

ii Registration and authorisation requirements

As previously mentioned, the Law creates two different legal regimes, one applicable to managing entities that fall outside the scope of the AIFMD and other to those that fall within the scope of the AIFMD.

Each legal regime has different registration requirements, with the registration procedure applicable to managing entities that fall outside the scope of the AIFMD being softer than the one applicable to entities within the scope of the AIFMD (which require authorisation in advance), as summarised below.

Registration requirements applicable to managing entities that fall outside the scope of the AIFMD

The setting-up of private equity funds and commencement of activities by private equity investors and private equity companies (regardless of whether they directly own a portfolio of investments or have the sole purpose of managing private equity funds, or a combination of both activities) is conditional on having previously registered the activity with the CMVM.

However, there is a simplified procedure that is applicable whenever the capital is not offered to the public and the investors are qualified investors or, regardless of the type, when the minimum capital subscribed by these investors is equal to or greater than €500,000 for each investor.

Authorisation requirements applicable to managing entities that fall within the scope of the AIFMD

The Law sets out stricter registration requirements for those management entities that fall within the scope of the AIFMD.

The commencement of activities of such management entities is subject to a prior authorisation by the CMVM.

The standard of information required for this authorisation request is, in this particular case, rather extensive, requiring significant support documentation, as these managing entities raise more concerns from the community and national legislators on account of their size.

If the CMVM fails to reply to the application request within the prescribed time frame, the application is considered to have been rejected.

iii Tax regime

At the level of the funds

Private equity funds set up and operating under Portuguese law are exempt from Portuguese corporate income tax (CIT) on capital gains, dividends, interest and any other sort of income received either from Portuguese or foreign sources. This CIT exemption means private equity funds will not be able to claim foreign tax credits that might be levied on investments made abroad.

The simple reimbursement of the capital invested by the investors is not taxed.

The setting-up of a private equity fund and subsequent capital increases do not trigger stamp duty or any other sort of taxation. Depending on the type of commission charged to private equity funds, indirect taxation could be levied.

At the level of Portuguese tax-resident investors (individuals or corporations) or non-resident investors with a permanent establishment in Portugal

Income paid or made available by private equity funds (by means of distributions, redemption of fund units or by virtue of liquidation) to investors that are Portuguese tax residents, or to non-residents with a permanent establishment located in Portugal to which the units are allocated, is subject to a 10 per cent withholding tax, except in the case of investors that benefit from a general tax exemption.

Withholding tax (if any) constitutes definitive taxation of Portuguese tax resident individual investors acting outside the scope of a commercial, industrial or agricultural activity, unless they opt to aggregate the income deriving from the participation units to global income, which is then subject to progressive personal income tax at rates of up to 48 per cent.[18] If this were the case, if income distributed included dividends, only 50 per cent of the dividends would be considered for personal income tax assessment purposes.[19]

For other investors, withholding tax constitutes a payment on account of the final tax liability and is levied at the following rates: (1) standard corporate income tax rate of 21 per cent, in relation to corporate entities;[20] and (2) the general progressive personal income tax rates of up to 48 per cent,[21] applicable to individual investors acting within the scope of a commercial, industrial or agricultural activity.

Capital gains obtained by Portuguese tax resident investors through the sale of units in private equity funds are subject to taxation at the following rates: (1) standard corporate income tax rate of 21 per cent[22] for corporate entities; (2) the general progressive personal income tax rates up to a maximum rate of 48 per cent[23] for individual investors acting within

18 The maximum rate of 48 per cent is applicable to income up to €80,882, plus an additional solidarity rate of 2.5 per cent imposed on income exceeding €80,000 and up to €250,000, and of 5 per cent on income exceeding €250,000.

19 Fifty per cent of dividends included in income paid or made available by private equity funds to Portuguese tax-resident individual unitholders acting within the scope of a commercial, industrial or agricultural activity shall also be considered, provided they are included in the organised accounting regime.

20 Plus municipal and state surcharges, if applicable.

21 See footnote 18 above.

22 See footnote 20 above.

23 See footnote 18 above.

the scope of a commercial, industrial or agricultural activity; and (3) a flat-rate personal income tax of 10 per cent for individual investors acting outside the scope of a commercial, industrial or agricultural activity, unless they exercise the option for aggregation.

At the level of non-resident investors (individuals or corporations) without a permanent establishment in Portugal

Income paid or made available by private equity funds (by means of distributions, redemption of fund units or by virtue of liquidation) to non-resident investors without a permanent establishment in Portugal, and the capital gains obtained by the investors from the sale of their units, shall not be subject to withholding taxes, to the extent that (1) the unitholders are not resident in clearly more favourable tax jurisdictions[24] and (2) in the case of corporate entities, Portuguese residents do not hold share capital in the entity, directly or indirectly, of more than 25 per cent. When these conditions are not met, Portuguese taxation is levied at a rate of 10 per cent on both the income distributed by private equity funds and the capital gains derived from the sale of the corresponding units, except where a double-tax treaty has been entered into between Portugal and the unitholders' state of residence granting exclusive right to tax this type of income and gains to the beneficiaries' state of residence, in which case no Portuguese taxation is due.

Finally, investors will not be considered to have a permanent establishment in Portugal simply by virtue of having invested in the fund.

IV OUTLOOK

The outlook for fundraising in Portugal in 2021 is particularly uncertain. On the one hand, observers are anticipating a general surge in dealflow given the pandemic-induced market dislocation, which could lead to an increase in fundraising activity. On the other hand, the significant liquidity that is expected to be received and allocated by the Portuguese government can encourage some international investors to adopt a more wait-and-see approach until they gain more visibility.

24 As listed by Ministerial Order No. 150/2004, dated 13 February 2004, and subsequent amendments.

Chapter 14

SOUTH KOREA

Chris Chang-Hyun Song, Tae-Yong Seo and Sang-Yeon Eom[1]

I GENERAL OVERVIEW

Regulations on onshore private equity (PE) funds[2] were first introduced in South Korea in 2004 following the enactment of the Indirect Investment Asset Management Business Act. In 2009, this Act and the Securities and Exchange Act were integrated into a new law known as the Financial Investment Services and Capital Markets Act (FSCMA), which primarily regulates fundraising, formation, management and operation of private equity funds in South Korea. Since 2004, there has been a remarkable growth in the South Korean PE fund market, with the number of PE funds increasing from two in 2004 to 583 as at the end of 2018.[3]

During the early years following the introduction of PE funds in South Korea, limited partners (LPs) were mostly financial institutions. However, as the PE fund market expanded, large pension funds such as the National Pension Service (NPS) have been actively participating as anchor investors. More recently, the number of smaller PE funds, with a commitment amount of 100 billion won or less, has been increasing, and project-based funds formed to acquire specific investment targets compose more than 70 per cent of all PE funds registered with the Financial Services Commission (FSC).

Previously, only financial institutions such as banks, securities companies and asset management companies acted as general partners (GPs); however, the number and variety of institutions acting solely as general partners has increased, and as a result, they now compose 66 per cent of the total number of GPs in South Korea.

The first table below indicates the number of registered PE funds in South Korea and the second table refers to the total commitment amounts and total invested amounts in recent years.[4]

Year	2013	2014	2015	2016	2017	2018	2019
Number of funds	237	277	316	383	444	583	721

1 Chris Chang-Hyun Song, Tae-Yong Seo and Sang-Yeon Eom are partners at Shin & Kim LLC.

2 New technology business investment partnerships prescribed in the Specialised Credit Finance Business Act and venture investment partnerships prescribed in the Act on Promotion of Venture Investment are similar to a venture capital fund as used in the United States and Europe, and can be considered as a private equity fund in a broader sense. For the purposes of this chapter, we discuss the private equity fund governed by the Financial Investment Services and Capital Markets Act.

3 Financial Supervisory Service, September 2019.

4 Source: Financial Supervisory Service, September 2019.

Year	2013	2014	2015	2016	2017	2018	2019
Total commitment amount (A)(×100 million won)	439,999	512,442	585,180	622,261	626,032	745,012	843,000
Total invested amount (B) (×100 million won)	280,844	317,634	383,903	435,931	455,353	557,103	617,000
Investment ratio (B)/(A)	63.8%	62%	65.6%	70.1%	72.7%	74.8%	73.2%

The table below indicates the number of PE funds, sorted by volume of commitment amounts.

Year	Total commitment amount	2013	2014	2015	2016	2017	2018	2019
Large	At least 300 billion won	47	51	57	53	48	51	59
Medium-sized	100 billion to 300 billion won	76	100	115	127	130	146	182
Small	Up to 100 billion won	114	126	144	203	266	386	480
Total		237	277	316	383	444	583	721

The table below indicates the number of institutions acting solely as GPs (independent GPs) and the number of financial institutions participating as GPs (FI GPs).

Year	2016	2017	2018	2019
Independent GPs	115 (60.5%)	138 (66%)	152 (65.5%)	210 (69.1%)
FI GPs	75 (39.5%)	71 (34%)	80 (34.5%)	84 (30.9%)
Total	190	209	232	300 (100%)

In a statement dated September 2018, the FSC announced its plan to integrate two categories of private placement fund – specialised investment private fund (hedge fund) and management participation private fund (PE fund) – into a single regime, and as such, we expect fundamental changes to the regulation and operation of the PE fund market in South Korea. The major changes to the FSCMA announced by the FSC are discussed in detail in Section III.

II LEGAL FRAMEWORK FOR FUNDRAISING

i Incorporation of a PE fund

The legal form of a PE fund in South Korea is a corporate vehicle, limited company under the Korean Commercial Code (KCC), which is similar to a limited partnership in US law. The formation of a PE fund requires a minimum of one GP with unlimited liability and one LP[5] with limited liability. In practice, nearly all GPs act as managing partners of PE funds.

The qualification requirements for an LP are as follows:

a professional investors as prescribed in the Enforcement Decree of the FSCMA (mostly financial institutions and pension funds); or

b individuals, corporations or other organisations investing at least 300 million won (100 million won for an executive officer of a GP or a fund manager) in a PE fund.

5 In practice, however, it is required to have at least two LPs, as a PE fund is subject to dissolution if the number of LPs is less than two. This does not apply where a pension fund becomes the sole LP of a PE fund.

As PE funds are also categorised as private placement funds, the total number of members must be 49 or below. A filing with respect to the incorporation of a PE fund must be made to the FSC within two weeks of the registration of its incorporation with the court.

ii Registration requirements for GPs

When the PE fund regime was first introduced in South Korea in 2004, there was no statutory licence or qualification requirement for a GP. In 2013, the FSCMA was amended to include certain requirements for an entity contemplating becoming a GP in South Korea. To register as a GP, the following conditions must be satisfied:

a a minimum capital of 100 million won;
b compliance by each executive officer of the GP with Article 5 of the Act on Corporate Governance of Financial Companies;
c employment of at least two individual fund managers;
d setting up of an internal compliance policy to identify, assess and manage the possibility of conflicts of interest; and
e maintaining sound financial standing and social credibility as prescribed in the Enforcement Decree of the FSCMA.

iii PE fund asset management methods

The asset classes that a Korean PE fund is permitted to acquire are narrow. The FSCMA requires a PE fund to participate in the management of its portfolio companies and to manage its assets in the following manner:

a it must acquire 10 per cent or more of the issued and outstanding shares with voting rights in a target company;
b if an investment is being made in relation to less than 10 per cent of the issued and outstanding shares or the total capital amount, the investment must allow the exercise of de facto control over the target company's material management issues;[6]
c the investment must be in equity-linked bonds (i.e., convertible bonds (CBs), bonds with warrants (BWs) and exchangeable bonds (EBs)) issued by the target company for the purpose of point (a) or (b), above;
d derivatives transactions can be carried out for the purpose of mitigating risks related to investment in securities issued by the target company and fluctuation in currency exchange rates;
e investments can be made in securities issued by an investment company for infrastructure purposes in accordance with the Act on Public-Private Partnerships in Infrastructure; and
f investments can be made in securities issued by a special purpose company (SPC).

Further, the following restrictions apply to PE funds' management of investment assets under the FSCMA:

a a PE fund is required to invest at least 50 per cent of its assets in the manner stipulated in points (a), (b), (e) and (f), above;

6 In practice, retaining a right to appoint one or more directors of the target company is deemed as exercising a de facto control over the target company's material management issues.

b a PE fund must retain the securities acquired in the manner stipulated in points (a), (b) or (c), above, for at least six months and must not dispose of them within a six-month period;

c a PE fund is not allowed to invest in the shares of a foreign corporation if 30 per cent or more of assets held by such foreign corporation and its subsidiaries (out of their total assets) is located in South Korea; and

d a PE fund is permitted to incur an indebtedness if (1) it is unavoidable for repaying a contribution amount to a departing member, (2) there is a temporary shortage in operating costs, or (3) there is a temporary shortage of funds for an investment in a target company, provided that the total indebtedness may not exceed 10 per cent of the net asset of the PE fund.

If a PE fund enters into a transaction where it is permitted to exercise a put option for its shares of the target company at an exercise price calculated based on the PE fund's internal rate of return (IRR) during the investment period on a condition that the target company does not satisfy its initial public offering obligation within the agreed period to protect the PE fund's invested capital and the IRR, the FSC has held that the PE fund's investment in the target company is interpreted as a de facto loan, and further held that it was in violation of the PE fund's asset management method under the FSCMA.

Since the first introduction of the PE fund regime in South Korea, there have been concerns that chaebols (large, family run conglomerates) would be likely to exploit the PE fund scheme for the purpose of expanding their businesses or unfairly supporting their affiliates. The FSCMA includes the following provisions to prevent potential abuse of the PE fund by chaebols.

If a PE fund that is an affiliate of a 'business group subject to limitations on cross shareholding' (a 'restricted business group') as prescribed in the Monopoly Regulation and Fair Trade Act, or a PE fund whose GP is an affiliate of a restricted business group, acquires a target company as an affiliate, it must sell its shares in the target company to a third party other than its affiliate.

A PE fund that is an affiliate of a restricted business group or a PE fund whose GP is an affiliate of a restricted business group is prohibited from acquiring equity securities of an affiliate.

iv Incorporation of an SPC

The FSCMA allows an investment by a PE fund by way of incorporating an SPC. Requirements for establishing and operation of an SPC are as follows:

a the SPC is a joint stock company or a limited company under the KCC;

b the SPC is in compliance with the provisions related to a PE fund's asset management method in the FSCMA;

c a shareholder or a member of the SPC is the PE fund, an executive officer of the target company, the major shareholder or a person designated by the Enforcement Decree to the FSCMA, provided that the PE fund's shareholding ratio in the SPC is 50 per cent or above;

d the sum of (1) the number of shareholders of the SPC or the number of members of the PE fund and (2) the number of non-PE fund shareholders or members, is 49 or below; and
e the SPC does not employ a full-time executive officer or staff and does not maintain a place of business other than a head office.

An SPC may borrow up to 300 per cent of its net assets and, therefore, a PE fund may make a leveraged investment in a target company by way of incorporating an SPC.

v Monitoring of PE fund by regulators

In South Korea, the FSC and the Financial Supervisory Service, the executive body of the FSC, oversee PE funds and GPs managing the PE funds. If an onshore PE fund or a GP violates the relevant laws, the FSC has the power to do the following:
a cancel its registration;
b suspend all or part of its business;
c demand that the PE fund dismiss, suspend from duty or issue a warning or admonition with regard to its officers;
d issue a warning or admonition against the PE fund;
e demand that the PE fund dismiss, suspend from duty, reduce salaries of, reprimand, or issue warnings or admonitions to, its employees; or
f issue a remedial order or demand certain measures for compensation of the damages incurred by its investors.

III REGULATORY DEVELOPMENTS

The FSCMA provides the general legal framework for the PE fund regime, including incorporation of a PE fund, asset management and requirements of GPs and LPs, among other matters. A meeting of members of a PE fund, liquidation of a PE fund and other business affairs that are not governed by the FSCMA are covered under the KCC. Since the inception of the PE fund regulations, there have not been many changes from a regulatory perspective; however, there were significant amendments to the PE fund-related provisions of the FSCMA in 2015. Some of the important changes are noted below.
a Previously, registration with the FSC was required prior to the incorporation of a PE fund. This has been changed to allow a filing with the FSC after the incorporation of the fund.
b A PE fund is not allowed to make investments in the shares of a foreign corporation if 30 per cent or more of the assets held by such corporation and its subsidiaries (out of their total assets) are located in South Korea. The previous threshold rate was 5 per cent.
c Previously, a PE fund was prohibited from incorporating multiple layers of SPCs (i.e., having its first SPC incorporate a second SPC, and so on). This is no longer applicable, and a PE fund may have multiple layers of SPCs.
d A strategic investor can become a member of an SPC. Previously, only a PE fund, an executive officer or the major shareholder of a target company could become a member of an SPC.

At the end of 2016, the amendment to the FSCMA introduced PE funds specifically designed for the purpose of investing in start-up companies and venture companies (start-up and venture PE fund). The start-up and venture PE fund enjoys certain corporate tax benefits if it invests 50 per cent or more of its assets in a venture business or a technology and innovation-driven small or medium-sized enterprise within two years of its incorporation.

Under the current FSCMA, private placement funds in South Korea can only be categorised as hedge funds or PE funds, and can be largely distinguished as follows.

a A hedge fund may invest in securities, loans, derivatives and real estate assets, whereas a PE fund's investment is limited to equity securities or equity-linked bonds, such as CBs, BWs or EBs, further provided that the PE fund acquires shares with 10 per cent or more of voting rights through such investment (or alternatively, the PE fund can be granted with the right to appoint one or more director of the target company as a condition to its investment). On the other hand, a hedge fund is prohibited from acquiring shares with voting rights of 10 per cent or more when making investments in equity securities or equity-linked bonds.

b A hedge fund is allowed to incur an indebtedness of up to 400 per cent of its net assets, whereas a PE fund is generally prohibited from incurring an indebtedness (aside from a few exceptions) but an SPC may incur up to 300 per cent of the net assets of an SPC if the PE fund is making investment via the SPC.

c There are stricter requirements for fund managers of hedge funds in terms of capital requirements, professional managers and major shareholder requirements when compared with those of PE funds.

In September 2018, the FSC announced that there would be an amendment to the FSCMA to reform the private placement fund scheme in South Korea. Under the newly amended FSCMA, the FSC will only allow a single type of private placement fund that will integrate the hedge fund and PE fund schemes. According to the FSC's statement, the major changes will be as follows.

a The integrated private placement fund ('integrated fund') will be able to invest in shares, loans, derivatives or real estate assets. Notably in relation to the securities investment, there will no longer be any minimum or maximum limitation on the shareholding in a portfolio company.

b The integrated fund will be permitted to incur indebtedness of up to 400 per cent of its net assets.

c The fund manager of the integrated fund will be required to comply with the current requirements for a hedge fund manager.

d GPs of existing PE funds that cannot comply with the current requirements for a hedge fund manager will be able to manage an integrated fund in which only institutional investors (as prescribed in the FSCMA) participate as LPs.

e Previously, the standard of distinguishing a public offering fund and a private placement fund was whether a solicitation of offer was made to 50 or more parties; in the newly amended FSCMA, the threshold will be whether 50 or more parties have actually accepted the offer.

At the time of writing, the proposed amendment to the FSCMA is pending at the National Assembly.

IV OUTLOOK

Since the first introduction of the onshore PE fund scheme in 2004, there has been a continuous growth of the PE fund market in South Korea. In particular, there has been a remarkable expansion in the market in the past decade, and, in fact, PE funds have been leading South Korea's M&A sector for many years. It is expected that the South Korean PE fund market will continue to grow in the near future while large pension funds, such as the NPS, will continue to play the role of anchor investor to large PE funds.

One of the current features of the South Korean PE fund market is that secondary PE funds are not yet very active compared with in seasoned PE markets such as the United States and the European Union. This is mainly because a few large pension funds tend to widely allocate their investments to various PE funds, which results in overlapping of LPs in many PE funds. However, the need for secondary PE funds has been developing and it is expected that the number of secondary PE funds will increase.

Additionally, it is expected that the private placement fund market will grow rapidly once the above-mentioned proposed amendment to the FSCMA expands the scope of investment methods and asset classes, and eases the standard of being recognised as 'private placement'. Existing GPs will have to decide whether they should increase the size of their capital and professional manpower to continue their business as fund managers of integrated funds under the new regime, or whether they should maintain the current capital volume and manpower, and maintain their status as fund managers for private placement funds for institutional investors.

Chapter 15

SPAIN

Carlos de Cárdenas, Alejandra Font, Manuel García-Riestra and Víctor Doménech[1]

I GENERAL OVERVIEW

Similarly to many other European countries, investment, divestment and fundraising activities in Spain were affected by the covid-19 pandemic during 2020.

Such activities almost ground to a halt until the end of the first half of 2020 as general partners (GPs) concentrated on protecting their portfolio companies from the side effects of quarantines and closure of offices, business and retail stores by rolling out different initiatives, enhancing liquidity and seeking protection of their workforce under the furlough scheme implemented by the Spanish government.

Conversely, during the second half of 2020, Spanish GPs returned to the market to take advantage of the upcoming opportunities that could be triggered by such an unprecedented situation.

In absolute terms, after reaching all-time records in 2019, investments and divestments in 2020 respectively decreased by 39 per cent (€5.561 billion) and 62 per cent (€1.131 billion)[2] as the M&A market was completely closed until the end of the first half of 2020 when the first megadeal was announced. But there are some positive notes; namely, middle market transactions reached an all-time record by volume, the international attractiveness of Spanish targets as 75 per cent of the total invested amounts were deployed by international funds, and an all-time record in number and volume was reached in venture capital investments.[3]

In terms of fundraising by Spanish GPs, a total amount of €2.026 billion was raised in 2020 according to ASCRI estimates. This represents an increase of 6 per cent if compared to the 2019 figures, and the dry powder of Spanish GPs stands at around €4.5 billion and €5 billion.[4] For the second year in a row, the total amount fundraised through venture has exceeded €700 million, though the average size of the funds is still below international venture capital funds.

According to the information available at the public register of the Spanish National Securities Commission (CNMV), a total of 33 private equity funds, 44 private equity companies, 14 closed-ended funds, 12 European Venture Capital Funds (EuVECA) and 15 management companies have been incorporated into the register of the CNMV in 2020.[5]

1 Carlos de Cárdenas, Alejandra Font and Manuel García-Riestra are partners and Víctor Doménech is of counsel at Alter Legal SL.
2 2020 estimate figures published by the Spanish private equity association ASCRI on 21 January 2021.
3 ASCRI, 21 January 2021.
4 ASCRI, 21 January 2021.
5 Information obtained from www.cnmv.es.

In terms of limited partners (LPs), according to data provided by ASCRI, there has been a very relevant increase in the commitments subscribed by family offices and high net-worth individuals (HNWIs) supported by the ongoing low interest rate scenario and lack of appealing yields in traditional assets. Additionally, public institutions, such as Fond-ICO, have continued their contribution to the fundraising market by providing funding to new private equity funds and putting more emphasis on venture capital and growth strategies.

In essence, the fundraising market is continuing the trend of previous years and becoming more mature with the entry of new players as a consequence of the spin-off of teams from historical private equity firms, the creation of new business lines by Spanish private equity firms and the launch of new teams focusing on less common investment strategies in the Spanish private equity market (private debt, special situations, social impact and funds of funds with exposure to niche strategies).

During this atypical year, renewable energy and infrastructure funds have attracted great interest because of their greater resilience to covid-19 side effects and, in similar terms, venture funds as investment in technology and digitalisation is increasing in the wake of the many opportunities and challenges brought by remote working and e-commerce.

Finally, there has been a noteworthy increase in the number of continuation funds and GP-led transactions that occurred in 2020 as part of a defensive strategy to isolate certain treasure assets, or as an offensive strategy to provide additional funding for expansion or potential add-on opportunities that may arise in the coming years.

II LEGAL FRAMEWORK FOR FUNDRAISING

The great majority of private equity funds in Spain are structured as domestic private equity funds (FCRs) or private equity companies (SCRs), incorporated under Law 22/2014 of November 12 on Venture Capital Entities.

FCRs are separate pools of assets without legal personality, represented by units, which are held by investors or unitholders. SCRs are Spanish public limited liability companies subject to a particular regulatory and tax regime pursuant to Law 22/2014 and also subject to the provisions of the Spanish Corporate Law.[6] FCRs and SCRs (collectively, ECRs) must be registered with the Spanish Securities Exchange Commission (CNMV).

FCRs are not subject to legal requirements generally applicable to corporations that give shareholders substantial rights to participate in, or to control, a board of directors (as is the case for SCRs). The role of investors in FCRs is generally passive, which makes FCRs more appropriate for investment funds managed independently.

Private equity funds organised as ECRs invest mainly in equity instruments issued by non-financial, non-real estate, unlisted target companies. They may also grant 'profit-sharing loans' to companies, subject to certain requirements and limitations. Likewise, ECRs may extend their main purpose to the investment in: (1) securities issued by companies whose assets comprise more than 50 per cent of real estate (provided that the real estate representing at least 85 per cent of the total book value of the target entity's real estate is ancillary to the development of an economic activity);[7] and (2) in other ECRs subject to the diversification requirements established in Law 22/2014.

6 Spanish Companies Act (Legislative Royal Decree 1/2010 of 2 July).

7 Pursuant to Law 35/2006, 28 November on Personal Income Tax and the partial amendment of the laws of Corporate Tax, Non-Resident Income Tax and over Property).

There is no minimum number of investors or minimum investment requirements (although marketing to certain categories of investors may require a minimum commitment) and, as they are closed-ended vehicles, ECRs are not subject to redemption requirements or liquidity coverage ratios. ECRs are subject to diversification requirements (i.e., they may not invest more than 25 per cent of their assets in a single target company (or 35 per cent in target companies belonging to the same group)). ECRs may have different classes of units or shares, which may help to set up a more tax-efficient carried interest structure for founders and promoters.

Apart from the FCRs and SCRs, Law 22/2014 contemplates a third type of private equity fund: venture capital entities for small and medium-sized investments (ECRs-Pyme). ECRs-Pyme may adopt the form of FCR or SCR. ECRs-Pyme must generally invest at least 75 per cent of their assets in equity or equity-related instruments in non-listed, non-financial and non-real estate entities, having less than 250 employees and with annual assets not exceeding €43 million or turnover not exceeding €50 million. Diversification thresholds are raised to 40 per cent, both per target company and per group.

ECRs can be marketed to both professional and non-professional investors and enjoy a special tax regime as described in Section III below.

Due to their lack of legal personality, FCRs must by externally managed, while SCRs may elect between self-management (through their board of directors), and external management (i.e., to delegate the management of their assets to a fund manager).

The principal vehicles for managers in Spain are the management companies of collective investment schemes (SGIICs)[8] and the management companies of closed-ended collective investment schemes (SGEIC).[9] Any company whose main activity is the management of private equity structures must obtain authorisation to qualify as a management company from the CNMV under Law 22/2014 (which transposes the AIFM Directive[10] into Spanish law) and are subject to the supervision of the CNMV. European Union (EU) management companies authorised under the AIFM Directive may also manage Spanish ECRs, ECR-Pymes and EICCs (as referred to below) directly (freedom to provide services) or through a Spanish branch.

In addition to ECRs, the Spanish Law on Venture Capital Entities, regulates two types of close-ended collective investment entities (EICCs):[11] (1) close-ended collective investment companies (SIICC) and (2) close-ended collective investment funds (FICC). EICCs are financial or non-financial closed-ended collective investment schemes with the ability to generally carry out any defined investment policy. They also have no minimum capital or assets. Otherwise, the rules on ECRs are applicable on a subsidiary basis to EICCs. EICCs can only be marketed to professional investors and they do not have a special tax regime (they are subject to the ordinary 25 per cent corporate income tax rate).

8 Collective Investment Schemes Act (Act 35/2003, of 4 November) and its implementing regulation (Royal Decree 1082/2012, of 13 July).

9 Venture Capital and Closed-Ended Collective Investment Schemes Act (Act 22/2014, of 12 November).

10 Directive 2011/61/UE, of 8 June on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No. 1060/2009 and (EU) No. 1095/2010.

11 Article 38 of the Venture Capital and Closed-Ended Collective Investment Schemes Act (Act 22/2014, of 12 November).

In line with the AIFM Directive, externally managed ECRs, ECR-Pymes and EICCs are not subject to prior authorisation requirements, but they must be registered with the CNMV before they can commence their activity. On the other hand, self-managed SCRs, SCR-Pymes and SICCs require authorisation by the CNMV prior to their incorporation.

Finally, the following close-ended fund vehicles are less frequently used in Spain, but are also available:[12] (1) European Venture Capital Funds (EuVECA); (2) European Social Entrepreneurship Funds (EuSEF); and (3) European Long Term Investment Funds (ELTIF).

Spanish managers focused on certain investment strategies, such as venture capital or direct lending, may find EuVECAs and ELTIFs an interesting alternative for structuring their funds. Spanish managers have incorporated ELTIFs, particularly in Biscay, where they enjoy a special tax regime for Biscay tax residents.

i Key items for disclosure

Disclosure requirements to potential investors when raising funds are outlined in Law 22/2014, of 12 November, on Venture Capital Entities. These requirements purport to ensure prospective investors adopt an informed investment decision.

There are two types of disclosure documents: the prospectus and the management regulations (FCRs) or corporate by-laws (SCR). The prospectus contains a description of the following items:

a information related to the ECR's investment policy and strategy and related risk factors;
b the procedures under which the ECR may amend its investment policy and strategy;
c the main legal effects arising from the contractual relationship entered into between investors and the ECR for the purposes of the investment;
d identification of the ECR's depository entity where applicable, ECR auditors and other service providers, together with a description of their obligations and investors' rights;
e a description of how the management company covers its professional liability risk;
f information on delegation arrangements of investment management functions by the management company and depository functions by the depository entity, including a description of potential conflicts of interest arising therefrom;
g valuation procedures and pricing methodology;
h the ECR's liquidity risk management including redemption rights;
i description of fees, costs and expenses that may be directly or indirectly borne by investors and the maximum limit thereto;
j a description of how the management company ensures fair treatment of its investors and information on any preferential treatment received by an investor (e.g., through bilateral agreements);
k the procedures and conditions for the issuance and sales of units and shares;
l historical performance where available;
m any prime brokerage arrangements where applicable and a description of how potential conflicts of interest are managed;
n a description of whether the depository or a sub-custodian may re-use and transfer the ECR's assets and the conditions upon which such practices are to be made;

12 Articles 39 and 40 of the Venture Capital and Closed-Ended Collective Investment Schemes Act (Act 22/2014, of 12 November), Regulation (EU) 345/2013 on European venture capital funds, Regulation (EU) 346/2013 on European social entrepreneurship funds and Regulation (EU) 2015/760 on European long-term investment funds.

o a description of any contractual arrangements made by the depository to discharge itself of liability; and
p a description of how and when periodic disclosure will be made to investors (leverage, risk profile, assets that are subject to special arrangements arising from their illiquid nature).

The ECR's management regulation and corporate by-laws are included as an exhibit to the prospectus.

Additionally, the management company is required to make available to investors, prior to the adoption of the investment decision, the ECR's latest annual report, net asset value according to the latest calculation and any investment delegation agreement, if any.

Further, given that shares of SCRs and units of FCRs qualify as packaged retail investment products (PRIP) under Regulation (EU) No. 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs), management companies are required to make available to retail investors the Key Information Document (KID) to assist investors to understand the performance and mechanics of ECRs (as investment products) and to compare the investment with other similar investment products.

ii Solicitation

The most common method of solicitation is by way of investor presentations, teasers and fact sheets to test investor appetite.

While institutional investors may request to conduct a comprehensive financial, commercial and legal due diligence concerning the investment and the fund management team, private wealth investors rely on their investment advisers' analysis and on the fact that the management company is a regulated entity subject to prudential and conduct of business supervision.

The management company may also appoint distributors, typically wealth management firms to solicit potential investors. Distributors must ensure that they comply with the applicable disclosure obligations under Law 22/2014 and PRIIPs as explained above, and their own disclosure obligations under the Spanish Securities Exchange Act and implementing rules and regulations.

iii Fiduciary duties

The management of ECRs is legally reserved to authorised management companies (SGEIC and SGIIC). Management companies are liable to investors for all damages suffered by investors as a consequence of the Management Company's breach of its obligations under Law 22/2014 and the provisions of the management regulations and corporate by-laws of the relevant ECRs.

Furthermore, management companies, their directors and managers (including de facto directors and managers) and senior officials are administratively liable for violations of the provisions of Law 22/2014 and subject to the sanctions stipulated under said law.

III REGULATORY AND TAX DEVELOPMENTS

i Regulatory

The CNMV is the competent authority for the supervision of management companies, ECRs and depository entities in Spain. The CNMV performs its supervisory activities both through on-site visits and remote supervision on the basis of information reported and submitted to it.

With respect to management companies, the CNMV performs its oversight duties by controlling their financial situation and solvency through periodic information (reporting obligations to competent authorities); controlling compliance with organisational requirements, means and functions; and controlling that public information requirements are complied with.

With respect to ECRs, the CNMV performs its oversight duties by controlling their financial situation and investment coefficients and restrictions through periodic information (reporting obligations to competent authorities) and controlling that public information requirements are fulfilled.

Lastly, the CNMV is the competent authority for the supervision of ECR depository entities. The CNMV performs its supervisory duties of depository entities by controlling compliance with its obligations relating to custody, recording of assets and the supervision and control of the management company's activities.

ECRs are not subject to authorisation by the CNMV provided they are managed by a management company. However, they are subject to registration in the CNMV's Official Registries of ECRs.

ECR sponsors are not required to be registered with the CNMV.

ii General tax overview

Direct taxation

The Spanish private equity funds set up as ECRs pursuant to Law 22/2014 are non-transparent entities and, therefore, their income is subject to Spanish corporate income tax (CIT) and are entitled, if they meet the applicable requirements, to the tax regimes, deductions, exemptions, treaties and incentives generally applicable to Spanish CIT payers.

In general terms, pursuant to the Spanish CIT general tax regime, entities subject to CIT will benefit from a 95 per cent exemption on dividends and gains (the General CIT Exemption)[13] obtained from their participation in resident and non-resident companies (except tax haven companies), when the following requirements are met:

a that the participation is held for at least one year and represents at least 5 per cent of the share capital of the investee company; and

b in the case of stakes in non-resident investee companies, that such companies be subject to a CIT that applies at least a 10 per cent tax rate (this is presumed to be the case for resident in a country that has a double tax treaty with Spain with an information exchange clause).[14]

If the investee company receives dividends or gains from participating companies that represent more than 70 per cent of its income, to benefit from this exemption for the income

13 Article 21 Law 27/14, of 27 November, del Impuesto de Sociedades (the CIT Act).

14 Spain has a very wide tax treaty network, covering over 90 different countries.

received attributable to such indirectly held company, the indirect holding in such entity must also comply with the above-mentioned requirements; in particular, if such dividend or gain was not subject to taxation in the directly held company or came from a tax haven jurisdiction.

Notwithstanding the above, pursuant to Article 50 of the CIT Act, ECRs do enjoy a privileged tax regime on dividends and gains derived from 'typical' or 'qualified investments' (as set out in the Law 22/2014), and also with respect to distributions made to Spanish corporate investors and non-resident investors (except tax haven investors) as described below.

Indirect taxation

Regarding capital duty or stamp taxes, at present, there is no capital duty applicable on the establishment or capital increase of ECRs or any other Spanish company. However, capital duty may be due in the case of a share capital reduction or winding-up of a private equity company that results in distributions to its investors (generally, 1 per cent over the amount obtained by investors). Notwithstanding the above, the use of adequate tax planning may help to reduce such capital duty.

As regards VAT, management fees paid by the ECR to its management company are specifically exempt from VAT. If, apart from the ECR management company, there are other sponsors or third parties that provide administration or advisory services to the ECR, such services may be subject to VAT depending on the nature of the services provided, which may result in tax inefficiencies.

Finally, the registration of the ECRs in the CNMV registries is currently subject to registration fees.

ECR CIT special tax regime

Dividends and gains obtained by an ECR from 'typical investments' in accordance with the Spanish ECR Law (generally, investments in non-listed companies – other than public to private transactions – that do not qualify as financial or real estate entities) will be subject to the ECR special tax regime, which, briefly, provides the following:[15]

a gains that do not qualify for the general CIT Act 95 per cent exemption that are obtained by the ECR from the transfer of securities representing a participation in the share capital of the investee company (considered as an ECR typical investment) will, nonetheless, benefit from a 99 per cent CIT exemption at the level of the ECR, provided that the investment holding period is longer than one year and does not exceed 15 years (subject to the approval of the Spanish Tax Authorities, this term may be extended to up to 20 years in certain cases). However, this 99 per cent exemption will not be applicable in the following cases:
   - if the acquirer is resident in a tax haven jurisdiction or the gain is obtained through a tax haven;
   - if the acquirer is to be considered related to the ECR pursuant to the CIT Act (unless it is another ECR); or
   - if the participation was acquired by the ECR from a related person or entity pursuant to the CIT Act; and

15 Article 50 of the CIT Act.

b dividends obtained by the ECR from such investee companies (except if obtained through a tax haven) will benefit at the recipient ECR level from the 95 per cent general tax exemption contained in Article 21.1 of the CIT Act, regardless of the investment holding period and the percentage stake held in the company paying out the dividend.

When the investments executed by the ECR are not considered as ECR typical investments, the gains and dividends obtained from them will be taxed at the level of the ECR in accordance with the general tax regime established in the CIT Act. Therefore, although the ECR will not benefit with respect to such investments from the above-mentioned ECR privileged tax regime, the ECR may be able to benefit from the general tax credits and exemptions applicable pursuant to the CIT Act (e.g., Article 21 of the CIT Act). Similarly, interest, royalties and any other income that do not qualify as dividends, distribution of profits or gains from ECR's typical investments will be subject to the CIT general regime at the ECR level.

Special tax regime for ECR non-resident investors

Income obtained by non-resident entities or individuals (without a permanent establishment in Spain for these purposes), deriving from their participation in the ECR (i.e., dividends, distribution of profits or capital gains from the reimbursement or transfer of their stake in the ECR, but excluding interest or other types of income) will not be considered to have been obtained in Spain for Spanish tax purposes and, consequently, will not be subject to taxation in Spain.[16]

Notwithstanding the above, if the income or gains received by the non-resident investor are attributable to income obtained by the ECR through a tax haven jurisdiction, this special tax regime may not be applicable and the relevant domestic rules and international tax treaties shall apply. Likewise, if the non-resident receives income from the ECR through a tax haven jurisdiction or when the acquirer is a tax haven resident, this special tax treatment shall not apply.

Pursuant to the above, non-resident investors may have to provide the ECR with a tax residence certificate regarding their specific non-resident status.

Special tax regime for ECR Spanish-resident investors

Spanish resident companies subject to CIT investing in ECRs will benefit from the ECR special tax regime as follows:[17]

a for gains obtained from the transfer or redemption of ECRs' shares or units – the Spanish CIT investor will benefit from the 95 per cent general CIT exemption regardless of the holding period and the percentage stake held in the ECR; and

b for dividends and profits distribution, the Spanish CIT investor will benefit from the General CIT exemption, regardless of the holding period and the percentage stake held in the ECR.

Notwithstanding the above, if the income or gains received by the Spanish resident company are attributable to income obtained by the ECR through a tax haven jurisdiction, this special tax regime may not be applicable and the CIT general regime may apply.

16 Article 50 of the CIT Act.

17 Article 50 of the CIT Act.

Finally, regarding Spanish resident individuals investing in ECRs, no particular tax regime applies, so the dividends and gains obtained will be fully subject to the general Spanish personal income tax regime.

Tax regime on ECR management companies

The ECR management company is subject to the general CIT regime and therefore its annual profits are taxed under Spanish CIT regular tax rates (25 per cent being the standard tax rate).

The management fees obtained from the management services provided to an ECR are exempt from VAT. Therefore, generally, VAT borne by an ECR management company will not be deductible (or may be partially deductible only), depending on the VAT pro rata applicable to the ECR management company, taking into account the services provided to other parties subject to VAT.

Other relevant tax considerations

With regard to carried interest, depending on the circumstances, it may be structured either as a success fee payable to the ECR management company (taxable under the CIT) or as a return from the investment made by the management company or other company or individuals, sponsors or promoters of the ECR. However, because of the lack of clear rules on this, and particularly following recent tax rulings, depending on the specific characteristics and conditions set out in each case, carried interest structured as a capital gain from investments may be contested by the Spanish Tax Authorities, who may regard such income rather than as a capital gain, as consideration for a service subject to taxation as such under the CIT or, if applicable, under Personal Income Tax general rules. As an exception to the above, a different set of tax rules have been set out for ECRs resident in Basque Country regions for resident individuals, under which carried interest may be considered as a capital gain.

Finally, the Spanish general or special tax regime applicable to ECRs contains a number of anti-abuse rules applicable to transactions made by ECRs with related entities, and to transfers to tax-haven residents and potential hybrid mismatch investments in line with the EU Anti-Tax Avoidance Directives (ATAD), which may result in the non-application of the ECR's special tax regime to certain transactions or the application of specific tax rules. Therefore, such rules must be considered when planning a transaction with related parties or involving tax haven residents, parties or accounts, as well as investments that may incur in hybrid mismatches.

iii Recent tax and regulatory developments

As set out above, in January 2021 certain amendments were introduced into the Spanish CIT; among others, its participation exemption regime, reducing the previously full exemption on dividends and gains to 95 per cent.

In 2020, the Spanish tax authorities issued a resolution clarifying the criteria to determine when a foreign entity should be considered tax transparent for Spanish tax purposes.

Finally, from a regulatory perspective, the approval of Regulation 2018/2088 and 2020/852 on sustainability-related disclosures in the financial sectors, is directly applicable to ECRs and their management companies; therefore, establishing certain new disclosure obligations in relation to environmental, social and governance matters towards their investors and regulators for the upcoming years.

IV OUTLOOK

Despite the fact that further rounds of quarantines, closures of offices, businesses and retail stores will have a very considerable negative effect on the Spanish economy, private equity activity may remain robust in Spain during 2021, depending on various factors, including: (1) how the ambitious vaccination programme of the Spanish authorities is implemented; (2) if the current level of liquidity in the market endures; (3) if the Spanish authorities involve the private equity sector in the deployment of EU covid-19 funds; and (4) if Fond-ICO continues to actively deploy its investment mandate.

Chapter 16

SWITZERLAND

Phidias Ferrari, Vaïk Müller and Pierre-Yves Vuagniaux[1]

I GENERAL OVERVIEW

In 2020, market studies showed that private equity funds remain an essential driver of M&A activity in relation to Swiss small and medium-sized enterprises.[2] During the first half of 2020, private equity firms, with financial investors acting as buyers or sellers were involved in around 40 per cent of the deals.[3] 2019 figures showed a total of around €2.2 billion raised by private equity funds in Switzerland.[4]

Despite the covid-19 pandemic,[5] Switzerland retained its top position as the world leader for innovation by the Global Innovation Index 2020.[6] Around 2.3 billion Swiss francs were invested in 266 Swiss start-ups in 2019, which thus received 85.5 per cent more funds than in 2018.[7] The information and communications technology, including fintech (ICT) and the biotech sectors played the primary roles. ICT start-ups attracted 1.2 billion Swiss francs in 2019, whereas biotech attracted 624.7 million Swiss francs, a 41 per cent increase compared with the previous 2017 record.

If during the 'hard' lockdown (March to April 2020) a certain number of fundraising activities were suspended or at least substantially slowed down, the subsequent partial lockdowns and travel restrictions had a limited impact on fundraising. Overall, despite the pandemic, Swiss innovative sectors, such as ICT and biotech, remain generally attractive.

1 Phidias Ferrari is a partner, Vaïk Müller is a senior associate and Pierre-Yves Vuagniaux is a partner at Tavernier Tschanz.

2 www2.deloitte.com/content/dam/Deloitte/ch/Documents/mergers-acqisitions/deloitte-ch-en-mid-cap-2020.pdf (p. 20).

3 https://home.kpmg/ch/en/home/media/press-releases/2020/07/damper-on-ma-business.html.

4 2019 figures (Invest Europe – European Private Equity Activity Report and Data 2007–2019).

5 It should be noted that the Cantons and the Swiss Confederation have implemented specific financing plans in 2020 for assisting start-ups amidst the covid-19 pandemic.

6 www.wipo.int/global_innovation_index/en/2020/.

7 www.startupticker.ch/uploads/VCReport_2020_web.pdf.

II LEGAL FRAMEWORK FOR FUNDRAISING

i General overview

The legal framework governing private equity fundraising in or from Switzerland is mainly articulated around the following laws and regulations:

a the Collective Investment Schemes Act (CISA) as supplemented by its implementing ordinances, the Collective Investment Schemes Ordinance (CISO), and the ordinance issued by the Swiss Financial Market Supervisory Authority (FINMA), the CISO-FINMA;

b the Financial Services Act (FinSA) as supplemented by its implementing ordinance, the Financial Services Ordinance (FinSO), in force as of 1 January 2020; and

c the Financial Institution Act (FinIA) as supplemented by its implementing ordinances the Financial Institutions Ordinance (FinIO), in force as of 1 January 2020, and the FinIO-FINMA, in force as of 1 January 2021.

In a nutshell: (1) CISA, CISO and CISO-FINMA focus on the product (i.e., the collective investment vehicle or the 'fund' as such); (2) FinSA and FinSO focus rather on the point of sale (i.e., the provision of the related services); and (3) FinIA and FinIO focus on the authorisation and regulation of service providers, in particular the fund managers or management companies.

ii EU AIFMD impact

The Directive 2011/61/EU (AIFMD) does not apply to Swiss investment fund managers or promoters, and more generally to Swiss-based entities given Switzerland is not a European Union (EU) Member State. In 2013–14, CISA and its implementing ordinances as well as the Swiss Funds and Asset Management Association (SFAMA) guidelines have been largely aligned with third-country requirements set forth in AIFMD. In 2015, Switzerland successfully passed the technical review of the European Securities and Markets Authority (ESMA) in view of EU passporting regime extension.[8] Since then, Switzerland has been waiting for a political decision from the European Commission.

iii Overview of FinSA, FinIA and CISA main changes

On 1 January 2020, with the entry into force of FinSA and FinIA, the fund marketing and offering rules have been significantly amended. Among other changes:

a the notion of 'distribution' and the corresponding exemptions set forth in old CISA have been repealed by the entry into force of FinSA, and replaced by the legal concepts of: (1) 'advertising'; (2) 'offer'; and (3) 'financial services' (see Section II.x for details on these concepts) and their respective exemptions. These concepts and the legal definitions associated with them are generally applicable to all financial products that are deemed to be 'financial instruments' as per the FinSA (such as equity and debt securities, structured products, derivatives, structured deposits and bonds). By their very nature, shares, units or interests in private equity funds are typically considered financial instruments;

b the licensing requirement for Swiss distributors has been repealed;

8 www.esma.europa.eu/press-news/esma-news/esma-advises-extension-funds-passport-12-non-eu-countries.

c a new classification of investors was introduced with three segments of clients: the institutional, the professional and the private (retail) clients and possibilities to move along certain of these categories via opting-in or opting-out mechanisms; institutional and professional investors are generally 'qualified investors' under CISA, whereas private clients will typically be qualified as 'non-qualified investors';

d the list of 'qualified investors' under CISA has been revamped and extended in particular with respect to per se professional clients;

e a limitation to the requirement to appoint a Swiss representative and a Swiss paying agent for offers of foreign funds to 'qualified investors'; and

f the application of certain rules of conduct and organisational requirements under FinSA to service providers acting on a local or cross-border basis as well as, under certain circumstances, the obligation for such providers to affiliate with an ombudsman office and to proceed with a registration of client advisers in a new register.

While the changes to the CISA and CISO in connection with the new FinSA and FinIA regime entered into force on 1 January 2020, a two-year transitional period applies for most of FinSA requirements until 31 December 2021. Until that date or before, subject to a full implementation of the FinSA rules of conduct and organisational measures, financial service providers, including foreign promoters, are required to ensure compliance with the former rules (including the entering into distribution agreements). In this context, changes to the former SFAMA guidelines have not yet been recognised by FINMA. It is currently expected that such recognition and corresponding publication of revised guidelines will not be available before the first quarter of 2021. In any instance, during the two-year transitional period, all existing former SFAMA documents may be used.

Affiliation obligation with the ombudsman office is in force as of 24 December 2020 and registration requirement with client adviser register as of 19 January 2021 (see Sections II.x and II.xi for concerned entities).

iv Jurisdiction and preferred vehicle for private equity investments

It is not uncommon for private equity fund promoters that are active in Switzerland to use offshore vehicles rather than Swiss structures. Among other drivers, access to the EU market plays an important role for promoters and using an EU vehicle facilitates the marketing. Tax aspects play also an important role, in particular for the investors, and may be key in the decision of a promoter to set up a Swiss or foreign vehicle (see Section III.ii on Swiss tax aspects).

By contrast to the past, the unregulated nature of the structure plays a less prominent role nowadays in the selection of the jurisdiction, in particular when a promoter wishes to target institutional investors, such as for instance pension funds. In certain cases, limited partners even refrain from investing in limited partnerships based in certain offshore jurisdictions, thus pushing promoters to set up structure in the EU or in Switzerland. Further, it has been noticed that certain 'small' promoters who have set up unregulated vehicles (in particular in EU jurisdictions) tend to consider switching to regulated structures to enlarge their investor basis.

When a foreign vehicle is used, its marketing and offering in Switzerland will be subject to certain requirements set forth in FinSA as well as in CISA, when such vehicle qualifies as a foreign fund under CISA. FinSA requirements will typically apply to the promoter, whereas

CISA requirements will concern the product. In practice, foreign LPs can only be marketed and offered to Swiss-qualified investors inasmuch as such funds are typically not eligible for registration for offering or advertising to non-qualified investors in Switzerland.

v Swiss limited partnership for collective investment (Swiss LP)

When Switzerland is selected to domicile the structure, the most frequently used legal vehicle for collective private equity investments is the Swiss limited partnership for collective investment (Swiss LP). A Swiss LP is a closed-end fund subject to a regulatory approval process and subsequent on-going prudential supervision by FINMA. It is based on a partnership agreement. A Swiss LP must issue a prospectus. As it is traditional for limited partnerships, at least one member of a Swiss LP is subject to unlimited liability (general partner), while the other members (limited partners) are liable only up to a specified amount (limited partner's capital contribution). Limited partners must be 'qualified investors', as defined in CISA. Limited partners may not be involved in the day-to-day management of the Swiss LP, but they are provided by law with certain information and governance rights. The general partner (GP) must be a company limited by shares with its registered office in Switzerland and can only be appointed as a GP of a single Swiss LP, unless the GP is authorised under FinIA as asset manager of collective assets (investment fund manager). If certain conditions are met, individuals controlling the general partner may also invest in the Swiss LP as limited partners.

vi Swiss investment company with fixed capital (SICAF) and investment club

A SICAF is a Swiss company limited by shares regulated under CISA. As a rule, a SICAF is subject to regulatory approval and subsequent on-going prudential supervision by FINMA. The sole purpose of a SICAF is the investment of collective capital. However, where a Swiss company limited by shares is listed on a Swiss exchange or when all shareholders of such company are exclusively 'qualified investors' under CISA,[9] CISA and the corresponding FINMA authorisation or supervision will not apply to such vehicle. Another exception is applicable to a company structured as an 'investment club' as defined in CISA (which, among other limitations, requires to restrict the club to a maximum of 20 investors).

vii Other available Swiss funds and investment foundations

Pooling of assets via fund structure can also be achieved via open-ended fund structures, such as Swiss contractual funds and Swiss investment companies with variable capital (SICAVs). That being said, except for very specific (and exceptional) cases and subject to initial investment redemption restrictions, such structures are generally not appropriate for illiquid investments, such as private equity, given they provide for on-going redemptions by investors.

Swiss pension funds may also set up specific investment vehicles under the form of Swiss investment foundations, including for investing in private equity. These foundations are not subject to CISA, but to the relevant provisions of the Occupational Retirement, Survivors' and Disability Pension Plans Act (OPA) and those of the Investment Foundations Ordinance (IFO).

9 CISA also specifies for non-listed companies that the shares must be registered shares.

viii Partnership key legal terms

The Asset Management Association Switzerland (AMACH)[10] and the Swiss Private Equity & Corporate Finance Association (SECA) have produced a model prospectus with an integrated partnership agreement, which should be part of any filing with FINMA in respect of a Swiss LP.[11] The GPs and the limited partners generally have a large room for adapting their contractual relationships to their needs.

A typical Swiss law governed partnership agreement will contain the following provisions:

a partnership name and its registered office as well as the corporate name and the registered office of the GPs;
b purpose of the partnership, in particular the type of sector in which the partnership will invest (e.g., biotech, fintech, etc.) and the overall investment strategy; the range of available investment strategies is rather broad and may include, inter alia, seed financing, venture capital, growth financing as well as secondaries or bridge financing;
c duration and possible extension of the partnership, noting that a Swiss LP may be set up for an unlimited period but, in practice, typical duration is often contractually limited between 10 to 12 years with generally a three-year extension;[12]
d subscription periods (initial and subsequent, including with conditions of admission of limited partners following the initial subscription period);
e total capital commitment and repayment of capital;
f partnership expenses and management fees (during and after the investment period), including management fees offset;
g conditions for admission and withdrawal of limited partners as well as interest transfer restrictions and conditions;
h limited partners information, including reporting duties of the GPs;
i the eligible investments (in connection with (b)), investment policy (including co-investment possibility and conditions), investment restrictions, risk diversification, the risks associated with investment, and the investment techniques (e.g., borrowing) as well as the investment period (typically between five to six years but longer periods are possible);
j delegation of certain tasks by the GPs (such as compliance, accounting and maintaining the limited partners' interest register);
k organisation of the partners' meeting, in particular voting quorum and majority, the delegation of management and representation;
l the appointment of a custodian or paying agent;
m distribution of proceeds (distribution waterfall models and conditions); and
n dispute resolution clause.

Except for a few mandatory provisions to be included in the partnership agreement and in practice generally already covered by the parties, and subject to non-objection by FINMA and mandatory Swiss contract law principles (which are rather flexible), it is possible to

10 The AMACH (www.am-switzerland.ch) is the result of the merger between the Asset Management Platform Switzerland (AMP) and the SFAMA.
11 These templates have not yet been updated to take into the account FinSA and revised CISA requirements.
12 A two-year extension has already been observed and promoters are free to structure their extension (i.e., two times one-year extension or one time two-year).

include other contractual provisions in the partnership agreement, such as, for instance, additional capital contribution for limited partners beyond their initial capital commitment, management fee stepdown models, key man, GP removal, ratchet-based or other models of carry, clawback, limited partners advisory committee (LPAC), most favoured nation (MFN), liability limitation and indemnification clauses.

ix Key items for disclosure

The Swiss LP and the GP must be registered with the commercial register of the canton where they are domiciled, respectively incorporated. The access to the commercial register is public in Switzerland. The commercial register provides general information regarding the Swiss LP and the GP, such as the capital (including the aggregate amount of the capital commitments of the limited partners), the registered office and the authorised signatories of the GP. The partnership agreement is also filed with the commercial register after its approval by FINMA. However, neither the financial statements of the Swiss LP nor the names of the limited partners nor their corresponding individual commitments are publically available.

In addition, any person or entity acquiring 25 per cent or more of the capital or voting rights of a non-listed Swiss company must notify such company of the acquiring entity's beneficial owner or owners and update such information in case of changes. In a typical private equity structure, the GP takes the relevant decisions regarding the fund and the underlying portfolio of companies. As a result, the individuals controlling the GP (respectively controlling the ultimate shareholder of the GP) should be disclosed as beneficial owners to the Swiss (non-listed) target company if the fund is acquiring 25 per cent or more of the capital or voting rights in such company. If such individuals cannot be identified in accordance with the Swiss disclosure rules, the Swiss company shall be provided with a negative declaration. However, the information disclosed is not publically available in the commercial register and will remain with the target company.

In addition, the SFAMA guidelines on the charging and use of fees and costs (Transparency Guidelines) requiring disclosure of retrocessions and rebates remain relevant under the new CISA regime (as of 1 January 2020). More generally, rules applicable to retrocessions and their disclosure, waivers and reporting and all relevant SFAMA guidelines (including the SFAMA Distribution Guidelines) will continue to apply at least until 31 December 2021 (or before upon full compliance with FinSA); further, transparency and disclosure of retrocessions have been generalised to all financial services providers in FinSA-dedicated provisions.[13]

Finally, Swiss GPs may also have to disclose information regarding 'total expenses' (TE) based on the guidelines for the calculation and disclosure of the costs of private market funds issued by the SECA.[14] According to these Guidelines, TE shall be published on an annual basis and be audited. These guidelines are of particular relevance for Swiss or foreign funds seeking to attract Swiss pension funds investors.

13 Such generalisation corresponds to a legal formalisation of past case law of the Swiss Supreme Court.

14 www.seca.ch/getattachment/0ed43bc9-20fb-4058-ad41-a63957cda731/TER-Richtlinien---Englisch.aspx.

x Swiss marketing rules overview (offer, advertising, financial services and related consequences, exemptions and concepts)

Under the new FinSA paradigm, an 'offer' is defined as any invitation to acquire a financial instrument that contains sufficient information on the conditions of the offer and the terms of the financial instrument. The following cases and activities do not constitute an 'offer':

a the provision of information in reverse-solicitation situations, where no advertising related to any specific financial instrument has been made by the financial service provider or an agent thereof;

b the nominal references of financial instruments, accompanied, where applicable, by factual information (e.g., international securities identification number (ISIN), net asset value (NAV), prices, information on risks, price trends, tax data);

c the mere provision of factual information; and

d the preparation, provision, publication and transmission to existing investors or financial intermediaries of information and documents prescribed by law or contract relating to financial instruments (e.g., general meeting invitations).

'Advertising' is defined as any communication aimed at investors that draw their attention to certain financial services or instruments. Any fund advertising must be clearly identifiable as such and it shall contain a reference to the prospectus and the key information document (KID) (if any)[15] and where such documents are available. In line with the exemptions applicable to the 'offer', the following situations and activities do not constitute an advertising:

a the nominal mention of financial instruments whether or not related to the publication of prices, rates, NAV, price list or changes or tax related data;

b announcements as regards issuers or transactions, in particular if they are prescribed by law or by rules specific to trading platforms;

c the provision or transmission by the financial service provider of an issuer's communications to existing clients; and

d articles in the specialised press.

The mere advertising of a foreign LP is assimilated to the offering of such LP triggering FinSA and CISA requirements.

The definition of a 'financial service' under the FinSA includes, inter alia, the provision of investment advice on financial instruments or portfolio management activities, but also the purchase or sale of financial instruments, such as shares, units or interests in funds: any activity addressed directly to certain clients that is specifically aimed at the acquisition or disposal of a financial instrument is considered a financial service (such as activities amounting to 'pure' distribution). That being said, only the provision of information on financial instruments to end investors or clients qualifies as a financial service, meaning that interactions with supervised financial intermediaries (e.g., a Swiss bank) are out of scope.

In addition, the provision of M&A and corporate finance advisory services is typically not deemed a financial service within the meaning of FinSA. In particular, the following activities are out of scope: (1) advice on structuring or raising capital as well as on business combinations, acquisition or disposal of participations and the services associated with such advice; (2) the placement of financial instruments with or without a firm commitment as

15 A KID is required when a financial instrument is provided to a private (retail) client.

well as the corresponding services; (3) financing within the scope of services provided in accordance with (1) and (2); (4) granting of loans to finance transactions provided that the financial service provider is not participating or otherwise involved (including by knowing that the loan will be used in connection with a transaction on financial instruments) in these transactions (e.g., the provision of a Lombard loan is typically considered a financial service). Further, the production and distribution of market research in connection with private equity investments is in principle not considered a financial service, unless the research material is presented as a personal recommendation.

In substance, when a financial service is provided, the following FinSA requirements will be triggered:

a client segmentation between institutional, professional and private clients;
b obligation to comply with rules of conduct;
c obligation to comply with organisational measures;
d affiliation with an ombudsman office in certain cases (see Section II.xi); and
e registration of client advisers in a register, except for Swiss financial service providers subject to FINMA supervision, as well as for foreign financial service providers subject to prudential supervision in their home jurisdiction, provided that they only provide financial services to institutional and per se professional clients (see Section II.xi).

Finally, any marketing activity in Switzerland is also subject to the Swiss legislation against unfair competition or business practice, in particular in relation to commercial communication with customers. Under the Swiss Unfair Competition Act (UCA), any behaviour or business practice that is deceptive or that infringes the principle of good faith in any other way with the result of affecting the relationship between suppliers and customers is deemed unfair and unlawful. The UCA could also apply in conjunction with CISA provisions prohibiting the use of confusing or deceptive fund designation.

xi CISA/FinSA main requirements overview

Under the revised CISA, subject to the transitional regime,[16] the appointment of a Swiss representative and a Swiss paying agent is only required in connection with offers or advertising of foreign funds targeting qualified investors that qualify as: (1) high net worth individuals (HNWIs); and (2) private investment structures established for HNWIs.

Both types of investors must, however, request to be treated as a professional client via an opting-out to be considered 'qualified investors'.[17] If no opting-out is provided, HNWIs and related structures are considered private clients. Concisely, under FinSA revised definition, HNWIs are individuals, who have financial (liquid) assets of 2 million Swiss francs or financial (liquid) assets of 500,000 Swiss francs and experience and knowledge about the specific product.

Other categories of 'qualified investors' include:

a 'institutional clients' (such as banks, securities firms, regulated insurance companies as well as regulated asset managers). These clients may request to be treated as professional clients; and

16 Where former rules and investor segmentation remain, in principle, applicable.

17 Unless funds units and shares or interests are provided or subscribed under a discretionary or advisory agreement, in which case even a private client may be considered a qualified investor (subject to certain conditions).

b 'per se professional clients' (such as pension funds and companies with professional treasury management, large companies and private investment companies with professional treasury management). These clients may request to be treated as private clients.

All institutional and per se professional clients may be approached without having to appoint a Swiss representative and a Swiss paying agent. Certain per se professional clients, namely companies with professional treasury management and pension funds, may request to be treated as institutional clients (opting-out). Swiss and foreign unregulated funds and their management companies, which are not already institutional clients under FinSA, may also request to be treated as institutional clients.

Notwithstanding the foregoing, if the promoter of a foreign LP is targeting HNWIs or corresponding investment structures, which have opted out, it will have to register itself with an ombudsman office. Further, according to a practice published in December 2020 by the client adviser registers, it will also have to register its client advisers (typically sales persons and other officers providing financial services). This registration requirement has been challenged by AMACH and certain professionals given it does not explicitly derive from FinSA provisions but until further notice it will remain applicable (as of 19 January 2020).

Until the end of the transitional period or before, upon full compliance with new rules, any offer or advertising of foreign funds to qualified investors will generally require compliance with the former rules, namely, in particular: (1) the appointment of a Swiss representative and a Swiss paying agent; and (2) the entry into of a written Swiss law-governed SFAMA compliant distribution agreement with the Swiss representative.

In accordance with transitional provisions, such requirements will not apply if only institutional clients are targeted or where the offer would not have constituted distribution under the former regime.

xii Fiduciary duties to investors

'Sponsor' and 'sponsorship' are notions that are not relevant from a regulatory standpoint. In particular, Swiss LPs and more generally Swiss funds are not required to have a sponsor *stricto sensu* for the purposes of the regulatory approval process or their operations. Notwithstanding the foregoing, limited partners' interests are protected under the terms and conditions set forth in the partnership agreement, which is the contractual cornerstone of all Swiss LPs. The obligations of the general partner, in particular its fiduciary duties towards limited partners find their roots in the partnership agreement as well. In addition, CISA duties of loyalty, due diligence and information (CISA conduct rules), as product-based conduct rules, are applicable to the general partners. The SFAMA Code of Conduct, which remains relevant, provides additional guidance on CISA conduct rules. Finally, contractual provisions limiting or excluding the liability of the GP towards the limited partners, while generally common, are ineffective in case of willful misconduct or gross negligence.

III REGULATORY DEVELOPMENTS

i Regulatory oversight and fund registration

FINMA approval is currently required prior to launching and operating a Swiss private equity fund irrespective of its legal form. Further to its licensing, the relevant vehicle is subject to the ongoing supervision of FINMA and prudential audits.

In the case of partnership structures, both the Swiss LP and its GP are subject to FINMA licensing and on-going supervision. The licensing process is generally conducted simultaneously for the partnership and its GP. The application is to be reviewed by a recognised audit firm. Individuals controlling the GP and any qualified participants (i.e., any legal or natural person or entity directly or indirectly owning at least 10 per cent of the capital or voting rights in the GP, or who may otherwise have a significant influence) must go through a FINMA fit and proper test. The partnership agreement is subject to FINMA approval but not the prospectus as such, even if it is filed with FINMA.

In terms of timing, for a typical Swiss LP structure, subject to FINMA's workload and in the absence of any unforeseen issue, FINMA will generally provide its authorisation within a three to four-month period once all the required documents are filed. In terms of fees, initial registration is comprised between 10,000 and 40,000 Swiss francs. FINMA further levies a yearly supervision fee, which is computed based on the assets of the Swiss LP.

Swiss management companies or investment managers (asset managers of collective assets) of a Swiss or non-Swiss funds are, in principle, subject to a mandatory licensing requirement in Switzerland under the FinIA. By way of exception, *de minimis* asset managers are only required to be authorised as invididual portfolio managers and not as asset managers of collective assets. An asset manager will qualify as *de minimis* if all investors in the relevant fund or funds are 'qualified investors' and if:

a the assets under management (AuM), including those resulting from the use of leverage, do not exceed 100 million Swiss francs;

b the AuM, excluding any leverage, do not exceed 500 million Swiss francs and the fund is closed for a period of five years as of the date of the initial investment; or

c the AuM belong to persons with whom the managers have business (e.g., group of companies) or family ties.

Under certain conditions, Swiss *de minimis* asset managers of foreign funds may request to be licensed by FINMA as asset managers of collective assets, if such licence is required by the jurisdiction where the relevant fund is domiciled.

Non-Swiss managers of both Swiss and non-Swiss funds with a branch or representative office in Switzerland are also required to register with FINMA in accordance with FinIA requirements. Advisory and marketing activities conducted in or from Switzerland by a fund promoter will often be construed as a financial service subject to FinSA requirements.

Even under the new FinIA regime, non-Swiss private equity vehicles may continue to make investments in Switzerland without being subject to FINMA's authorisation or supervision, provided, however, that such vehicles are not deemed to be effectively administered in or from Switzerland. Substance abroad and residence of general partners, directors or managers may have an impact on the localisation of effective administration in Switzerland. No registration of the foreign fund will be required, unless such fund is marketed or offered to 'non-qualified investors'.

ii Swiss taxation aspects

Taxation rules applicable to Swiss private equity vehicles remain the same as the previous year and the forthcoming introduction of the new Limited Qualified Investor Fund (L-QIF) will not change the situation (see Section IV).

In a nutshell:

a the Swiss LP is treated as a transparent entity for tax purposes and is therefore not subject to Swiss corporate income and equity taxes, except on income stemming from real estate investment located in Switzerland, directly held by the LP;

b the shares (interests) in the LP are taxed as an element of wealth; each limited partner is otherwise taxed on the income realised at the level of the LP, by transparency;

c the Swiss general partner, as a legal entity, is taxed on its annual net profit, mainly made of its compensation (i.e., management fee and carried interest), and on its equity, at normal corporate tax rates (income tax dramatically decreased in most Swiss cantons, as a result of the recent tax reform that entered into force on 1 January 2020; as an example, in Geneva City, the overall effective corporate tax rate was set at 14 per cent in 2020 versus 24.17 per cent in 2019);

d distributions made by Swiss LPs to both Swiss and foreign investors, as well as the undistributed income reinvested at the level of the LP, are subject to Swiss withholding tax (WHT) at a 35 per cent rate, unless such distributions qualify as capital gains or as income resulting from directly held real estate; the LP's accounts must make it possible to differentiate between taxable and non-taxable items;

e WHT refund or exemption or both are available as follows:
- Swiss-resident limited partners will generally receive full refund of WHT, if they declare the income in their tax return (individuals) or account for it in their financial statements (self-employed and companies);
- foreign-resident limited partners may be entitled to a full or partial refund depending on existing double-tax treaties (DTT) entered into between Switzerland and their State of residence; and
- foreign-resident limited partners may also qualify for a full WHT exemption under the affidavit procedure if at least 80 per cent of the LP's income is derived from non-Swiss source investments and the investors are not Swiss residents; this exemption is applicable irrespective of any existing DTT.

These tax principles are also applicable to CISA-regulated open-end funds. On the other hand, SICAFs and other investment companies incorporated as Swiss companies limited by shares and not regulated under CISA are considered non-transparent for tax purposes. Accordingly, such vehicles are subject to corporate income tax and tax on equity (net asset), and distributions (and only distributions or the like, as opposed to reinvested income) to shareholders are subject to a 35 per cent WHT as dividends. In addition, the issuance of shares of a SICAF or another investment company incorporated as a Swiss company limited by shares is further subject to the Swiss issuance stamp duty at a 1 per cent rate. Given this tax treatment, except in certain structures involving a foreign limited partner, SICAFs and other investment companies are rarely used in practice.

iii EU tax regulations impact

The mandatory disclosure regime of certain cross-border arrangements (DAC 6) is not directly applicable to Swiss-based taxpayers or their intermediaries. DAC 6 may, however, indirectly affect Swiss-based groups with operations or structures localised in the EU by imposing on Swiss entities a duty to communicate (at least on a contractual basis) to their European counterparts to allow the latter to comply with the EU requirements. This duty to communicate may also be relevant in the context of funds set-up for HNWIs if certain DAC 6 hallmarks are met. Further, the Anti-Tax Avoidance Directive II (ATAD II) also enters into consideration when structuring private equity investments. ATAD II may affect private equity structures and their investors in the context of cash repatriation, in particular dividend distributions and exits. Careful tax assessment of private equity structures, in particular in the cross-border context. will undeniably play an increasingly important role in the coming years.

iv EU data protection rules impact

Another piece of EU regulation that may affect private equity structures, in particular the general partners, managers and other advisers is the General Data Protection Regulation (GDPR). The GDPR may apply to Swiss-based companies doing business in the EU notwithstanding the fact that Switzerland is not an EU Member State. Even when GDPR is not directly applicable to Swiss companies, it may apply indirectly to them to the extent that EU business partners generally request their Swiss counterparties to comply with GDPR requirements, in particular in case of data processing (including sub-processing) in Switzerland.

IV OUTLOOK

In 2020, the Swiss Federal Council adopted the Dispatch regarding the introduction in CISA of the new L-QIF. This newcomer has been designed to increase the attractiveness of Switzerland as a place of domicile for the establishment of funds. The L-QIF and its documentation (e.g., prospectus, partnership agreement, marketing material) will not require an authorisation, licence or a product approval by FINMA, which should in turn facilitate quick launch and cost-efficient structures.

Based on the current draft law, L-QIFs can be set up in the legal form of open-end structures such as the Swiss contractual fund or the SICAV, or as a closed-end structure, namely the Swiss LP (but not as a SICAF). Open-end structures will be required to have a depositary bank. This bank is subject to FINMA supervision and in addition to its safekeeping role, it assumes a control function. Investing in an L-QIF is restricted to 'qualified investors' within the meaning of CISA.

An L-QIF is a flexible product: no limitation in terms of investment possibilities or risk diversification is currently imposed by law. In practice, risk management and limited partners' demands will probably impose certain limitations. However, this flexibility will allow L-QIFs to invest in various financial instruments and strategies, in particular for private equity and venture capital investments but also in more exotic underlyings, such as infrastructure project, luxury goods, wine, art, etc.

Despite the fund itself not being directly supervised by FINMA, it has to be managed by a FINMA-licensed and supervised institution and to be audited. On the tax side, the L-QIF will not represent a revolution to the extent that L-QIF will not benefit from any preferential tax treatment compared to existing fund structures. In other words, the current Swiss tax framework will apply to L-QIF to the same extent it applies to other existing CISA-regulated vehicles.

The revised CISA is currently subject to Swiss parliament review. For the time being, the availability of the L-QIF is expected for early 2022, along with the entry into force of the revised CISA.

Overall, L-QIFs are a welcomed legal development that, associated with traditional Swiss assets such as stable political and efficient legal systems, measured tax regimes and skilled workforce, may offer good opportunities for structuring certain private equity investments.

Chapter 17

UNITED KINGDOM

Jeremy Leggate, Prem Mohan and Ian Ferreira[1]

I GENERAL OVERVIEW

The fundraising environment in 2020 remained strong, despite the challenges posed, with private equity funds raising US$535 billion across 906 funds.[2] While this represents a 19 per cent reduction in the quantum of capital raised by private equity funds in 2019, this must be placed in the context of the ongoing covid-19 pandemic, global political and economic volatility and Brexit. In this context, US$535 billion of capital raised appears to show a surprisingly resilient market, especially considering that it represents a 15.63 per cent increase from the equivalent figure for 2018.[3] Notwithstanding the reduction in aggregate capital raised, the longer-term trend towards larger average fund sizes continued. In 2020, the average private equity fund size globally rose by approximately 6.29 per cent to US$507 million (compared with US$477 million in 2019) as investors appeared to double-down on larger ticket, more established sponsors amid the general market uncertainty.[4] Dealmaking was also slightly mixed compared with 2019: 2020 saw a decrease in the aggregate value of buyout deals announced, down to US$442 billion in 2020 compared with US$470 billion in 2019, but the equivalent metric for venture capital deals showed an increase of c. 25 per cent, increasing from US$287 billion in 2019 to US$357 billion in 2020.[5]

The increase in average fund size was particularly evident in, and driven by, the continued trend of increasingly larger buyout funds, which accounted for 50 per cent of the aggregate capital raised. Indeed, 2020 saw more than a quarter of private equity capital – US$136 billion (only approximately US$2 billion less than 2019) – raised by the 10 largest private equity funds. Drilling into these figures further, one is able to see the continued maturation of secondaries funds as a distinct sub-class among the 'mega' funds raised in 2020; of the 10 largest funds raised globally in 2020, four – Ardian Secondary Fund VIII (ASF VIII) (US$14 billion), Lexington Capital Partners IX (US$14 billion), Goldman Sachs Vintage Fund VIII (US$10.3 billion) and AlpInvest Secondaries Program VII (ASP VII) (US$9 billion) – were secondary funds. Perhaps even more strikingly, these four funds together represented 59.4 per cent of aggregate capital raised for secondaries strategies and 15 per cent

1 Jeremy Leggate, Prem Mohan and Ian Ferreira are partners at Kirkland & Ellis International LLP. The authors would like to thank David Pritchett for his contributions to this chapter.
2 Annual Fundraising Report 2020, Private Equity International.
3 Annual Fundraising Report 2019, Private Equity International.
4 Prequin.
5 ibid.

of all private capital raised (2019: 6 per cent).[6] Similarly, venture capital also increased its share of the aggregate private equity capital raised in 2020 to 15 per cent (2019: 9 per cent), significantly driven by the raising of Insight Ventures Partners XI (US$9.54 billion). Growth equity strategies raised 11 per cent (2019: 14 per cent) of total fundraising.[7]

The European private equity fundraising landscape has largely mirrored this trend to larger funds; notwithstanding the global drop in aggregate capital raised, European-focused funds raised US$63.27 billion in 2020, representing a modest increase over 2019's figure of US$62.6 billion, reversing the recent trend of fundraising growth in North America outpacing that of Europe.[8] This was largely driven by several European managers seeking to raise ever larger mega-funds, such as EQT IX (US$17.92 billion target), Apax X (US$10.5 billion target) and BC European Capital XI (US$10.00 billion target) (all still in market). From an investor's perspective, there is little indication that the flow of capital into private equity funds will slow down in 2021, not least given persistent near-zero (and sometimes negative) interest rates and the speed and scale by which private equity managers are able to raise capital during a time of covid-19 pandemic-related national lockdowns. In this regard, the impact of upper mid-market European funds cannot be overlooked: for instance, Hg Genesis 9 and Hg Saturn 2 (US$5.24 billion and US$4.85 billion, respectively), Vitruvian Investment Partnership IV (US$4.58 billion), IK IX Fund (US$3.1 billion) and Waterland Private Equity Fund VIII (US$3.04 billion) were key contributors to the aggregate European fundraising total for 2020.

As the evidence above suggests, and in much the same vein as for 2018 and 2019, investors remain focused on consolidating their general partner (GP) relationships and committing larger amounts of capital to fewer managers, though there is still appetite among investors to initiate new relationships where the opportunities present themselves. The long-term impacts of the covid-19 pandemic are of course still playing out, but we believe that there are two qualitative changes of particular note:

a the rise of virtual diligence: the travel restrictions imposed as a result of the pandemic have compounded the trend of limited partners falling back on established relationships, but this is not to say that it has prevented new relationships from being forged virtually. Indeed, the rise of virtual sessions has enabled some managers to build new relationships where distance might previously have made this impractical. Investors are willing to adapt to this new world – two-thirds of investors have indicated that they are willing to make an investment to a new fund manager without a face-to-face meeting[9] – and therefore the managers that are able to pivot to this 'new normal' will be better placed to raise capital going forwards; and

b fundraising velocity: the drive by managers seeking to raise capital going into the next stage of the economic cycle has led to multi-billion-dollar funds being raised in a matter of weeks. While this velocity is not necessarily a new phenomenon, the rise of virtual diligence, combined with investor regression towards established relationships

6 See further 'Large Firms Drove Secondary Fundraising to a Record US$76 billion in 2020', *WSJ Pro*, 15 January 2021.

7 Annual Fundraising Report 2020, Private Equity International; Annual Fundraising Report 2019, Private Equity International; 'European Managers Came Out on Top as Fundraising Slowed Last Year', *WSJ Pro*, 15 January 2021.

8 Annual Fundraising Report 2020, Private Equity International.

9 LP Pulse Survey, Eaton Partners, 24 September 2020.

> and a particular focus on those managers with strong track records, has facilitated this speed through the market and, ultimately, the continued disparity between the haves and have-nots, as we have consistently reported on since 2015.[10]

In short, with private equity funds continuing to hit post-global financial crisis deal making highs,[11] new funds will continue to be raised and managers with strong differentiators (in particular, strong track records) and a willingness to adapt to the 'new normal' will be best placed to take advantage of market opportunities.

II LEGAL FRAMEWORK FOR FUNDRAISING

i Jurisdiction and legal form

The key drivers in any fund structure are generally those of limited liability, tax transparency and efficiency, ease of use and flexibility. Notwithstanding the wide range of possible structures that could be utilised, a limited partnership structure is the vehicle of choice for most fundraisings being led out of the UK.[12] As expanded upon further below, the general trend is for the fundraising market to adopt two main strategies for structuring: (1) being located within the European Economic Area (EEA) (thus being subject to the full range of applicable tax and regulation, including – in whole or part – the Alternative Investment Fund Managers Directive (AIFMD)) or (2) being located offshore (thereby being outside of the EEA VAT and regulatory net). While Brexit has not prevented managers from continuing to do business out of the UK (as further detailed below), it has impacted the choice of jurisdiction when structuring funds.

The former strategy would generally utilise an onshore limited partnership, historically an English (potentially together with a Scottish) limited partnership, but in light of Brexit (in particular the UK ceasing to be part of the European Union (EU) – a 'third country' for AIFMD purposes – and accordingly not being able to rely on the AIFMD marketing 'passport'), managers have generally favoured the Luxembourg limited partnership (SCSp), which is modelled on the Anglo-Saxon limited partnership. Other structures, including Luxembourg SICARs, SIFs, RAIFs and French FCPIs or offshore companies, can also be used, although these structures are not the focus of this chapter. There may be a reversion back to English limited partnerships in the event that the EU grants the UK equivalence or otherwise access to the 'third country passport' regime, resulting in UK managers being able to market UK-based structures freely across the EU, but any such development is not expected in the near future (see Section III.i at 'Extension of AIFMD Passport').

The latter strategy would generally involve the use of an offshore-domiciled limited partnership – generally Guernsey or Jersey – although the former seems to be the favoured jurisdiction for offshore private equity funds, albeit with increasing competition from Jersey. Other possibilities include Delaware, the Cayman Islands and Bermuda, but these are very much the exception in the context of a UK or European fundraising, primarily because of time zone, strength of local service providers, investor familiarity and, increasingly, the inclusion of some on certain European jurisdictions' tax 'blacklists' (despite the removal of

10 See further 'Fewer funds gobble up LP capital as YTD fundraising remains strong', Private Equity International, 14 October 2020.

11 'Private equity dealmaking defies pandemic to hit post-crisis high', *Financial Times*, 23 December 2020.

12 Structures aimed at the retail market, such as VCTs, are not considered here.

the Cayman Islands from the 'EU Blacklist'[13] in October 2020). Post-Brexit, the UK may grow as a rival 'onshore' alternative to the aforementioned 'offshore' jurisdictions given its newfound 'third country' status with regard to the EEA and continuing investor sentiment to move away from what the perceived reputational risks of utilising 'offshore' jurisdictions; however, any structuring decisions would need to be tempered against the other tax and regulatory benefits that offshore jurisdictions might afford.

Some investors have preferences as to the location of the fund (usually because of the applicable regulatory or tax regime), and this may have an impact on the jurisdiction of the fund or its structure, or both; feeder vehicles or tax 'blockers' may have to be incorporated into the structure to cater for the specific needs of a single investor or a group of investors.

While each GP will claim to have a set of unique terms relating to its fundraising, there are a number of themes that are common to all, albeit with different formulations and treatments between various funds. While not comprehensive, the main negotiated terms of a private equity fund are as follows.

Target size or cap

The target size of the offering is of relevance to investors as they may wish to impose limits on the size of the fund to ensure that it is not too large for the team to manage, thereby ensuring that they focus on transactions of an appropriate size and in appropriate volume for their investment strategy. Thus, investors may seek to cap the size of a fund and, conversely, seek to subject their commitments to a size precondition (i.e., they would only be bound to invest if the fund reaches a 'viable' size), thereby ensuring that they would not be over allocated to that fund or that the fund would have to make smaller investments in size or number.

GP commitment

The size of the personal commitment made by the executives and its form (i.e., whether financed personally, by waiver – uncommon in the UK and European market and increasingly uncommon globally as investors seek to ensure that managers and their executives' commitments are in 'cash' – or by some other method) is also very pertinent to prospective investors who want to ensure they have 'skin in the game'. Because of investor pressure, the expected number has been steadily increasing and is now likely to start at 2 per cent of fund commitments, although there is wide variation.[14]

Closing period

This is the period during which more investors can be admitted to the fund. The 'market' position tends to be 12 months from the first closing of the fund; however, managers have argued for an increase as a response to the increase in time required to fund raise and deal with investor due diligence, etc. Investors have generally accepted this extended period, notwithstanding their concerns that the management team would be distracted from deal sourcing and investment activity by their fundraising efforts, with a limited partner advisory

13 The EU list of non-cooperative jurisdictions for tax purposes, as published in the *Official Journal of the European Union*.

14 ILPA Principles 3.0, 'General Partner Commitment' states that 'the GP should have a substantial equity interest in the fund. The GP commitment should be contributed in cash as opposed to contributed through the waiver of management fees or via specialized financing facilities'.

committee consent mechanism being included if required. While the very best GPs will raise new funds with relative ease when compared to other market participants, on the whole, GPs are being made to work harder than ever before to win commitments, with more firms and funds than ever before working across a broad spectrum of strategies and the average fundraise for buyout funds historically taking longer than 12 months in 8 out of the last 10 years.[15]

Investment period

This is the period during the fund's life reserved for investing. The manager will have full discretion to draw down all the funds available during this period (subject to relevant limitations such as investment policy and borrowing restrictions). Here, the old status quo of a five-year investment period is also being modified. Managers, in an attempt to avoid failing to invest their funds fully in the allotted period have argued for the ability to extend their investment periods. This has been met with a variety of responses from investors, some of whom were sympathetic provided that the approval mechanisms were satisfactory, and others who were unmoved and wanted to ensure that their commitments were time-limited to five years. If the investors wish to retain the five-year investment period, other points of compromise may be a widening of the ability for managers to complete deals 'in process' at the end of the investment period.

Management fee

It is usual for the management fee to be calculated as a flat percentage of committed capital during the investment period, stepping down to a (in many cases reduced) percentage of drawn-down or invested capital after the end of the investment period or on the raising of a successor fund. Investors are very sensitive regarding the scale of management fees and their impact on returns, and thus there has been some downward pressure and heightened scrutiny by investors, albeit with relatively limited success to date.

Investment strategy and limitations

The offering will specify the appropriate investment strategy to be followed by the fund and relevant limitations providing, for example, limits in relation to maximum exposure to any one investment sector, jurisdiction or industry limitations, as applicable. The investment strategy and limitations are an essential part of any fundraising, and investors are focused on ensuring that they understand any risks and to ensure that there is no 'strategy drift'. The growth in importance of certain sovereign wealth funds, state-aided funds or political agencies has resulted in a number of pools of capital (e.g., EU regional aid) that are solely focused on a single jurisdiction or that are prohibited from investing in certain regions. To cater for this demand, a number of exclusions to the investment policy may be negotiated, 'sidecar' vehicles with a restricted investment mandate for investing alongside the main fund established or, if demand is sufficient, dedicated separately managed accounts formed to cater to the bespoke requirements of these specific investors.

15 Global Private Equity Report 2020, Figure 1.21, Bain & Company.

Investment-related fees

In most cases all transaction fees, break-up fees, directors' fees or monitoring fees would be set off against the management fee so that the investors would receive some or all the benefit thereof, and investors have been pushing strongly, and often successfully, for a full set-off in their favour.[16] These types of fees, and critically the full and accurate disclosure of such fees to investors, are also under increasing regulatory scrutiny, notably by the US Securities and Exchange Commission (SEC), which is affecting some major managers' readiness to charge such fees, and hence affecting the market position more generally. Innovation has been seen in certain managers developing in-house capabilities to provide consulting, corporate finance and other 'value-add' services to their portfolio companies, with the manager able to leverage their familiarity with the portfolio companies to provide services at or below a market-rate that third-party service providers might be able to provide. Provided that the rationale is adequately explained to investors, managers may be able to retain all or a portion of such arm's length fees, provided that there is full transparency to investors regarding the services provided and the fees charged.

Preferred return

There is a general lack of movement with the preferred return, notwithstanding today's low/negative-interest-rate economic environment, and it remains relatively constant in buyout funds, at 8 per cent per annum. Although some funds, most notably some of the largest private managers, have created more bespoke arrangements, they are still very much in the minority, and generally investors prefer less creativity in the structuring of the preferred return mechanism.

Carried interest or distribution mechanism

The standard carried interest payable to the manager, its executives, or both, in private equity funds is 20 per cent of the fund profits. There are two main methodologies for calculating the carried interest – the 'fund-as-a-whole' mechanism and the 'deal-by-deal' mechanism. The former method is most common in Europe, while the latter is most common (although its popularity is dwindling) in the United States. The fund-as-a-whole model is the main European model and is deemed to be investor-friendly in comparison with the deal-by-deal method; and although some high-demand European managers are moving towards the US model, most investor negotiations are based around mitigating the risk of any overpayment of carried interest (see below). Premium carry (where a manager is rewarded with an increased carry percentage above certain performance thresholds) or a movement (in whole or in part) to a deal-by-deal as opposed to a fund-as-a-whole waterfall is a signature of some of the best performing funds; however, neither mechanism is commonplace across the industry as yet.

Escrow or carried interest clawback

These provisions can be rather bespoke, as a number of facts and circumstances are relevant – for example, the distribution mechanism of the fund (see above), the creditworthiness of the carry recipients and the likelihood, in light of the investment strategy, of losses post receipt of carry. The fund-as-a-whole distribution model provides that the carried interest is payable

16 Institutional Limited Partners Association (ILPA) Principles 3.0, 'Fee Income Beyond the Management Fee'.

only after investors receive an amount equal to the aggregate drawn capital and the preferred return thereon, thereby reducing the risk of any carry overpayment. As such, in Europe, despite the efforts of certain larger LPs, European managers are increasingly relying on clawback mechanisms rather than escrow accounts, which are more commonplace for funds with deal-by-deal waterfalls, as carry can be paid ahead of investors' total aggregate drawn capital being returned to investors. Whether one or the other is used is often in response to the nature of the investors' likely return or drawdown profile and the executives' attitude to risk (i.e., whether they prefer an escrow or subjecting themselves to a later clawback risk).

Reinvestment

The ability for a fund to redraw prior distributions is of great importance to the manager to ensure that the fund manager has access to the full amount of investor commitments for the purpose of making investments, including amounts that may have originally been drawn down for management fees or other expenses, bridging investments, etc. The limited partnership agreement will typically set out the type of distributions that can be redrawn and for how long. Certain investors, such as a fund of funds, may be unable to redraw from their own investors and thus push back strongly in this regard, but certain other investors will appreciate managers' use of reinvestment to reduce the spread between 'gross' and 'net' performance figures.

Exclusivity

This regulates what other funds the manager can raise, and when. This provision comes under discussion as management houses contemplate setting up bespoke side funds or managed accounts, or when the manager attempts to diversify into a multi-product asset management platform (an issue particularly relevant in light of the continued proliferation of managers seeking to raise complementary products (e.g., credit funds) alongside more traditional buyout strategies).

Default provisions

These set out the suite of remedies in relation to investors who default on drawdowns. In light of experiences since the most recent global financial crisis, and threatened and actual defaults, these provisions have become more extensive in scope. The increased protection for managers, and subsequent investor scrutiny of the knock-on effects to the fund in the event of an investor default, include provisions around management fee coverage and assignment of defaulting investors' interests in the fund.

Key-man or suspension-of-investment-period provisions

These provisions have received a lot of investor attention over the past few years. They protect the investors from a 'key-man event' (i.e., if one or more of the key management personnel ceases to be involved in the management of the relevant fund). As expected, the trigger event is heavily negotiated and specific to each fund and manager, and thus much time and attention is given to this particular provision in fund documentation. This term is often linked with the exclusivity provisions, as the ability for a team to perform different functions for different funds is often curtailed.

Removal of the GP on a fault or no-fault basis

These provisions, alongside the key-man provisions (see above), are governance provisions, which have been developing in fund documentation. The relevant voting thresholds and the implications for management fees and carried interest in the event of the removal of the GP are often fiercely negotiated as investors seek to ensure that they are sufficiently protected from a manager that has lost its way.

Most-favoured nation (MFN)

The MFN provision entitles other investors to benefit from rights given by side letter or otherwise to other investors. Given the increased proliferation of side letters, managers seek to limit applicability by size of commitment, legal status, timing of admission, etc., to both prevent against an ever-increasing administrative burden, but also to ring-fence the terms offered to larger, cornerstone or 'first-mover' investors.

Other negotiable terms

The high level of competition for investors' capital and the enhanced due diligence referred to above has resulted in increased investor attention and negotiation on a number of key terms (most mentioned above). The main themes behind investors' negotiations have been increased alignment of interest, governance and transparency – indeed, these are the three guiding principles enunciated in the ILPA Private Equity Principles Version 3.0 published in June 2019[17] – and while, in ILPA's own words, the Principle should not 'be applied as a checklist, as each partnership should be considered separately and holistically', taken together with the ILPA Model Limited Partnership Agreement, they are revealing as to the concerns of the investor community and serve as a useful basis for discussions on terms. The ILPA is increasingly influential as its members also press managers to report in accordance with its standard format. Another theme in this market that is having an impact on terms is that of incentives for first closers or large investors. This is often given in the form of a reduced management fee or other economic incentive, although other incentives can be utilised, such as preferred access to co-investments alongside the fund or other enhanced rights. This is increasingly becoming a permanent feature for fundraisings in this market, and a number of funds currently in the market are reported to be offering such incentives.[18]

ii Key items for disclosure

The legislative backdrop set out in the UK Financial Services Act 2012 (FSA) makes it a criminal offence for any person knowingly or recklessly to make a statement, promise or forecast that he or she knows to be misleading, false or deceptive; or dishonestly to conceal any material facts, if he or she does so for the purpose of inducing, or is reckless as to whether it may induce, another person to engage in investment activity.[19]

Furthermore, a misrepresentation can occur under English law when an untrue statement of fact or law is made that induces the other party to enter into a contract and suffer a loss. An action for misrepresentation can be brought in respect of a misrepresentation of fact or law. There are three types of misrepresentation: fraudulent misrepresentation,

17 See https://ilpa.org/ilpa-principles/.

18 See www.pehub.com/2014/10/incentives-part-of-routine-offering-from-gps-on-fundraising-trail/.

19 Section 89 of the FSA.

negligent misrepresentation and innocent misrepresentation. If a party is found to have made a misrepresentation that induced another party into entering in a contract, there are various remedies that may be awarded by the courts depending on which type of misrepresentation has been found to have occurred. Generally, the remedies for misrepresentation are rescission or damages according to the form of misrepresentation.

In addition, it is usual for a UK-domiciled manager to be authorised by the UK financial services regulator, the Financial Conduct Authority (FCA). It would also have to comply with the FCA's rules, including the wide-ranging Principles for Business, which include obligations to pay due regard to the information needs of clients and to communicate information to them in a clear, fair and non-misleading manner, and with legislation and rules implementing the AIFMD that prescribe certain information disclosure requirements (including post-Brexit).

US securities laws and other legislation relating to disclosure and fiduciary duties, while outside the ambit of this chapter, would also be pertinent, as most UK offerings would be extended to US investors, and thus misstatements, omissions or other misleading content may lead to SEC enforcement, federal or state action or civil action. European jurisdictions typically also impose similar 'anti-fraud' requirements.

As such, it is important that the manager performs a verification exercise to ensure that the investor has subscribed on the basis of the best available facts; the manager thereby minimises the risk of damages claims, recession claims or regulatory sanctions should the fund fail to perform as anticipated. As part of this, the manager will review the offering documents and other related promotions to ensure that all facts and circumstances that will be relevant to a potential investor have been adequately disclosed without material omissions, that all statements of fact are accurate, that statements of opinion are reasonable and are honestly held by those to whom they are attributed, and that all inferences that can be drawn from any of those statements are themselves accurate.

As a matter of best practice, this verification process should be performed by the manager before issuance of any promotional documents.

The main key items for disclosure to investors are usually set out in the final form offering memorandum, which would typically set out:

a the investment highlights, providing a detailed discussion of the investment strategy for the fund and the process by which investments will be made;

b the track record of the manager or of the relevant executives comprising the management team;

c the resume of the key executives and relevant experience;

d a market overview, so as to provide investors with a macro view of the investment therein;

e the summary of key terms (see above);

f legal and tax matters, describing various regulatory and tax considerations in making an investment in the fund;

g risk factors, so as to make the investors aware of the risks inherent in an investment in the fund; and

h a summary of the investments referred to in the track record of the manager, thereby providing the investors with further data and other experience at a granular level.

iii Solicitation

The most common method of solicitation is by way of an offering memorandum, although this document evolves through a number of stages. It is first conceived as a 'teaser' pitchbook, which is distributed to potential investors to solicit their initial interest or as a follow up to preliminary meetings or due diligence. This is then developed into a draft offering memorandum, which is usually circulated to potential investors and is the main promotional document used for the 'soft-circling' or 'hard-circling' process before concluding discussions and circulating a final form offering memorandum to investors before the fund's first closing. This process would also take into account the relevant AIFMD marketing strategy of the firm (see Section III).

In parallel to this process, it is common for the manager to establish a data site (usually electronic) containing further information on the manager, track record, executives, legal documentation and structure of the offering. Certain investors also tend to issue their own document and information requests in the form of a due diligence questionnaire (DDQ), which the manager must complete and return. Indeed, so common has the DDQ approach become that many managers now pre-complete a 'standard' DDQ for inclusion in the data site so as to expedite the due diligence process. The same considerations as to the accuracy of information provided in the offering memorandum apply to the information provided in the data site or DDQ responses.

Any changes to the terms or other relevant parts of the offering (e.g., track record or revised valuations) that arise as the fundraising progresses are typically communicated to investors by way of an addendum to the offering memorandum.

The manager may also appoint a placement agent who would assist in the preparation of the suite of offering documents and in identifying and soliciting potential investors.

Throughout this process the manager and the placement agent, if applicable, must ensure that they comply with the AIFMD and the relevant marketing regulations of the pertinent jurisdiction of the investor (including the UK), make any required filings and disclosures, and obtain any required authorisation. While not the subject of this chapter, this body of law has been developing and is becoming more extensive (including with various lobbyist and 'pay-to-play' restrictions in the United States), and sophisticated placement agents or managers will now generally seek access (through their legal or marketing advisers) to regularly updated global surveys of the marketing or pre-filing and registration rules of each jurisdiction to ensure that the offering complies with local laws and regulations.

III REGULATORY DEVELOPMENTS

i Regulatory developments

Overview of AIFMD

The AIFMD is the principal legislation constituting the regulatory framework applicable to the marketing and management of private equity funds in the UK and the rest of the EU. The AIFMD broadly applies to managers under the following two circumstances: non-EU managers who intend to market a fund to investors in the EU; and EU onshore managers who intend to either market a fund to investors in the EU or manage a fund in the EU.

At present, non-EU managers may continue to rely on existing private placement regimes in individual EU Member States[20] to market fund interests to institutional investors, subject to complying with certain minimum requirements under the AIFMD.[21] These provisions are a subset of the compliance obligations applicable to fully authorised EU managers, and include:

a prescriptive requirements detailing the information to be disclosed to investors prior to investment and on an ongoing basis;
b a requirement to produce an annual fund report with certain prescribed content;
c regulatory reporting requirements; and
d certain portfolio company transparency, disclosure and 'anti-asset stripping' provisions aimed at preventing private equity firms from making distributions from portfolio companies acquired by the fund other than out of profits.

For those EU jurisdictions that permit non-EU managers to actively raise capital under existing national private placement regimes, there is typically a requirement to register the fund in the respective jurisdiction ahead of any marketing. The level of detail involved in completing marketing registrations varies by jurisdiction, from straightforward notifications (after which a non-EU manager can commence marketing) to rigorous applications for marketing approval requiring extensive supporting documentation. Processing times are similarly varied, with some regulators permitting non-EU managers to market a fund immediately on the submission of a marketing notification, and others taking potentially three months to vet and approve applications for marketing approval.

The AIFMD gives EU Member States the discretion to impose stricter requirements on non-EU managers in addition to the minimum requirements set out above. These stricter 'gold-plated' requirements may flow from other provisions of the AIFMD (otherwise not applicable to non-EU managers). For instance, non-EU managers intending to market a fund in Denmark or Germany are required to appoint a depositary for that fund, an obligation that otherwise applies only to fully authorised EU managers (see below).

As a consequence of these registration requirements, a non-EU manager must consider, for each fund that it proposes to raise in the EU, the point in time at which it will have to register the fund for marketing with a local regulator. This in turn will depend on how local regulators interpret the term 'marketing' under the AIFMD.[22] In the UK, for instance, the FCA has taken the view that certain 'soft marketing' activities, such as the circulation of a promotional presentation on the fund or a draft private placement memorandum to UK investors, do not constitute marketing for AIFMD purposes. Consequently, firms may carry on such activities in the UK ahead of registering the fund with the FCA (on complying with

20 Some jurisdictions (notably Austria, France and Italy) have chosen either to terminate existing private placement regimes following the implementation of the AIFMD or to impose highly onerous compliance requirements that result in effectively precluding a non-EU manager from marketing a fund using private placement.

21 The private placement regimes in Member States were initially expected to be closed in late 2018 or early 2019. However (as explained later in this section), the timetable for these events will now depend on when (if at all) the EU lawmakers complete the necessary steps to extend the passport on a voluntary basis to non-EU managers.

22 The AIFMD defines marketing as a direct or indirect offering or placement, at the initiative of the manager or on behalf of the manager of units or shares of an alternative investment fund it manages, to or with investors domiciled or with a registered office in the EEA.

the UK financial promotion regime). Regulators in other EU Member States may (and some do) adopt a different interpretation of marketing, potentially leaving a non-EU manager with a narrower range of permissible soft-marketing activities that can be undertaken in those jurisdictions before registration. To the extent permitted by a local regulator, soft marketing enables a non-EU manager to gauge whether there is sufficient investor interest in a particular jurisdiction to justify the initial registration and ongoing AIFMD compliance costs for marketing a fund in that jurisdiction.

The preamble text to the AIFMD clarifies that the requirements under the AIFMD are not intended to apply to situations where an EU investor invests in a fund of its own initiative. This 'reverse solicitation' carve-out is (depending on facts and circumstances) being relied on by non-EU managers who receive indications of interest and requests for additional information from investors in an EU jurisdiction who have not otherwise been solicited by the manager.

The concepts of 'soft marketing' and 'reverse solicitation' under the AIFMD have been harmonised across the EU Member States as a part of the implementation of the forthcoming Omnibus Legislation, as further discussed below.

EU managers whose assets under management exceed certain thresholds (see below) are subject to the AIFMD's full requirements. These requirements include applying for and obtaining permission to manage alternative investment funds from local regulators, and thereafter complying with a wide range of ongoing requirements on matters such as regulatory capital, internal governance, systems and controls, remuneration and, significantly, the appointment of a depositary to perform cash monitoring, safe custody, asset verification and oversight functions in relation to managed funds. In addition, the minimum disclosure and transparency obligations discussed above that apply to non-EU managers also apply to onshore managers. EU managers receive an important trade-off for complying with these onerous obligations, in that they benefit from an EU-wide 'passport' under the AIFMD that they can use to market EU funds to EU professional investors or manage funds across the EU, or both, without registering with local regulators. Despite the passport's intention of giving EU managers the freedom to market or manage EU funds without complying with local requirements, some national regulators have placed additional requirements on onshore firms using a marketing passport, which currently include appointing a local agent or paying a passporting fee, or both.

EU managers that are authorised under the AIFMD are currently not entitled to use a passport to market a non-EU fund in the EU. Rather, EU managers of such funds are placed on the same footing as non-EU managers in being required to register a non-EU fund for marketing in a particular jurisdiction under national private placement rules.

EU managers whose aggregate assets under management fall below the AIFMD's authorisation threshold[23] are not required to be authorised under the AIFMD and are only subject to a limited number of requirements under the AIFMD. They are not entitled to benefit from the marketing or management passport under the AIFMD.

Following the departure of the United Kingdom from the European Union (see 'Brexit' below), the UK's national private placement regime will apply to all non-UK managers, including those from the EU. The regime continues to provide for a relatively straightforward

23 Broadly, aggregate assets under management exceeding €500 million for unleveraged funds that do not have redemption rights exercisable during a period of five years from the initial investment in the fund; or €100 million for leveraged funds.

registration procedure, where non-UK managers may commence marketing a fund once a short marketing notification is completed and filed with the UK FCA. In carrying on any marketing activities in the UK, firms are required to continue complying with the UK's pre-AIFMD national marketing rules, the financial promotions regime.

PRIIPs

The requirements under EU Regulation No. 1286/2014 on key information documents for packaged retail and insurance-based investment products (the PRIIPS Regulation) became applicable on 1 January 2018. The PRIIPS Regulation requires firms to produce a key information document (KID) if they 'make available' a packaged retail and insurance-based investment product (PRIIP) to retail investors in the EU. The KID is meant to set out the risks, costs and expected returns of the underlying product in a standardised format, and is intended to help retail investors compare products. The rules have extraterritorial application, so they apply to both EU and non-EU managers who make PRIIPs available to retail investors in the EU.

The definition of a PRIIP is extremely wide and covers investment funds and related investment pooling vehicles. The rules do not contain express carve-outs for carried interest and co-investment vehicles, which managers might choose to make available to retail investors such as 'friends and family'-type investors and EU-based executives within their own organisations. Managers continue to review the application of the rules to these structures on a case-by-case basis.

These requirements will not be applicable to firms who market funds exclusively to large institutional investors in the EU, as such investors are likely to be treated as professional rather than retail investors. The rules state that retail investors may elect to be treated as professional investors in relation to a particular investment fund or type of investment fund, and they permit managers to treat such investors as elective professional investors (therefore not requiring managers to produce a KID in respect of such investors) subject to following a mandatory assessment and 'opt-up' procedure. In particular, this procedure requires managers to undertake adequate assessments of: (1) the expertise, experience and knowledge of the retail investor, to ensure that the investor is capable of making its own investment decisions and understanding the risks involved; and (2) the retail investor's recent investment activity, financial instrument portfolio and professional background, to ensure that these meet certain minimum prescribed criteria. In addition, the manager is required to make written disclosures regarding the protections that the retail investor might lose as a result of being treated as an elective professional investor.

Finally, following the implementation of the revised Markets in Financial Instruments Directive in the EU on 3 January 2018, local authorities in the EU and the UK (including local government pension schemes and their administrators) are treated as retail investors by default, and managers seeking to market investment funds to such investors without producing a KID would have to follow a different opt-up procedure to treat them as elective professional clients. The opt-up procedures for local authority investors may differ by EU jurisdiction, and managers should check the requirements on a case-by-case basis.

Extension of AIFMD passport

According to the AIFMD, the European Securities and Markets Authority (ESMA) may recommend that the benefit of the AIFMD marketing passport be extended to non-EU managers who choose to register with an appropriate EU regulator (their 'Member State of reference') and comply with the AIFMD in full. Pursuant to the AIFMD, the EU lawmakers are empowered to take the necessary legislative steps to extend the passport on a voluntary basis to non-EU managers within three months of receiving a 'positive' opinion from ESMA. After this time, non-EU managers choosing not to become fully authorised and compliant with the AIFMD may continue to market funds to EU investors on complying with local national private placement registration requirements, as well as the minimum requirements under the AIFMD applicable to them.

Under the AIFMD, this voluntary regime was initially expected to come to an end in late 2018 or early 2019, when it was anticipated that all national private placement regimes in the EU would be terminated and all non-EU managers would be required to become fully authorised under and compliant with the AIFMD.

ESMA has taken certain preliminary steps in publishing advice and opinions on the extension of the AIFMD passport to firms and funds in various non-EU jurisdictions on two separate occasions. On 30 July 2015, it concluded that Jersey, Guernsey and Switzerland presented no significant obstacles to the extension of the AIFMD passport. On 19 July 2016, ESMA issued positive advice with respect to the extension of the passport to Canada, Guernsey, Hong Kong, Japan, Jersey, Singapore and Switzerland and caveated opinions with respect to Australia and the United States.

The Commission, Parliament and the Council have been considering ESMA's advice and are yet to issue any formal communication on when they will take the necessary legislative steps to implement ESMA's advice. At the time of writing, the general view among industry participants is that these steps are not likely to be taken in the near future.

New rules on marketing funds in Europe

On 1 August 2019, the cross-border directive on distribution of collective investment undertakings and a related regulation came into force across the EU. Both pieces of legislation (together, the Omnibus Legislation) will start to apply following a period of two years (i.e., from 2 August 2021). The key changes under the Omnibus Legislation include:

a permitting authorised EU managers to undertake certain defined 'pre-marketing' activities, with a view to testing investors' interest in an investment fund, prior to obtaining a marketing passport for that fund. An AIFMD marketing passport will not be required where no subscription documents (including in draft form) are distributed, and no final form constitutional or offering documents are distributed to investors;

b EU managers will be required to notify their home state regulator within two weeks of commencing pre-marketing in any EU Member State;

c a formal limitation on managers' ability to rely on reverse solicitation, where a subscription within 18 months of the commencement of any pre-marketing activity will be deemed to have resulted from active marketing, triggering the passporting requirement under the AIFMD;

d allowing for the discontinuation of marketing and the removal of funds from EU regulators' registers (subject to certain conditions being met, including conditions relating to investor participation levels); and

e requiring EU managers seeking to appoint a third party to carry out pre-marketing on their behalf to ensure that such third party is a Markets in Financial Instruments Directive (MIFID) investment firm (or a tied agent of a MIFID investment firm, a Capital Requirements Directive IV credit institution, an Undertakings for Collective Investment in Transferable Securities management company or another EU AIFM).

In addition, the EU lawmakers are considering guidelines on marketing communications and this may further inform what, and to what extent, EU managers may present information on risks and rewards of the investment in a fund, information on past performance and what disclaimers need to be used during pre-marketing.

As drafted, the requirements under the Omnibus Legislation do not appear to apply to non-EU managers marketing under the national private placement regimes of EU Member States. However, the legislation expressly prohibits EU Member States from adopting laws and regulations that are more advantageous for non-EU managers, and as such, there is a concern that EU Member States may seek to impose similar requirements on non-EU managers.

AIFMD review

Article 69 of the AIFMD requires the European Commission to review the functioning of the AIFMD, in particular, its impact on investors within the EU and in third countries, and the degree to which its objectives have been met. In 2019, KPMG conducted a general survey addressed to the stakeholders that are most affected by the AIFMD and produced a report with its findings. The report is lengthy and provides an indication of the topics that are likely to be considered by the European Commission in its review. These include a lack of harmonisation in implementing the rules across EU Member States, non-effective reporting requirements, inconsistent leverage calculation methodologies, onerous requirements in respect of investments in non-listed companies and divergent approaches across Member States in implementing the AIFMD marketing passport. In addition, ESMA in August 2020 raised certain priority topics for consideration by the European Commission in its review of the AIFMD. ESMA proposes changes in the areas of delegation and substance, the use of hosting or 'white-label' service providers (such as third-party 'rented' AIFMs), calculation of leverage and the use of secondment arrangements.

The European Commission published a lengthy consultation on its proposed changes for industry review and comment in October 2020, with legislative proposals to follow in late 2021.

Brexit

On 23 June 2016, the UK electorate voted for the United Kingdom to leave the European Union and, consequently, on 29 March 2017, the UK government invoked Article 50 of the Treaty of the European Union, commencing the two-year period for negotiating the terms of the UK's withdrawal from the EU (Brexit). The European Union and UK government mutually agreed to extend the date of the UK's withdrawal twice. After a number of iterations, the European Commission and the UK's negotiators reached a provisional agreement on the terms of the UK's withdrawal from the EU in October 2019. The UK formally left the EU on 31 January 2020 at 11.00pm, after which the UK entered the transition period specified in the withdrawal agreement, which ended on 31 December 2020.

On 24 December 2020, the UK government and the EU Commission provisionally agreed a trade and cooperation agreement governing their future relationship, which requires ratification by both parties. At the time of writing, the trade and cooperation agreement still needs ratification by the EU Parliament, and subsequent adoption by the Council of the EU. Until such ratification and adoption are complete, the terms of the trade and cooperation agreement are set to apply on a provisional basis from the end of the transition period. The trade and cooperation agreement agreed between the UK and the EU is largely silent on market access for financial services. The UK and the EU made a Joint Declaration on Financial Services Regulatory Cooperation (the Joint Declaration). The Joint Declaration announced the UK and the EU's desire to work towards regulatory cooperation on financial services, with the aim of establishing a durable and stable relationship between autonomous jurisdictions, and declared their shared commitment to preserve financial stability, market integrity and the protection of investors and consumers. Importantly, the Joint Declaration states that the parties will discuss how to move forward with equivalence determinations.

Therefore, at present, UK-based financial services firms can no longer benefit from 'passporting rights' under EU legislation, including the marketing and management passporting rights currently available to UK managers authorised under the AIFMD, and are treated as a 'third country' manager and be subject to the same fundraising regime currently applicable to non-EU managers. As such, to fundraise in the EU, UK managers will have to comply with the initial registration and ongoing AIFMD obligations required under the national private placement regimes of individual EU Member States (as set out above).

For non-EU managers, it is unlikely that Brexit will prompt fundamental changes to the manner in which funds are currently marketed in the UK or elsewhere in the EU, and such managers are expected to continue to comply with the registration requirements under the UK's national private placement regime. However, when the EU lawmakers take the necessary steps to extend the AIFMD passport to non-EU managers, the UK will no longer be available as a Member State of reference for non-EU managers who opt to take advantage of the passport's extension.

EU sustainable finance regulatory initiatives

The EU, as part of a broader action plan, has introduced recent regulations that require EU managers to integrate sustainability considerations into its decision-making process, and provide investors and consumers transparency in this regard. The key regulations that affect EU and non-EU managers are Regulation (EU) 2020/852 (the Taxonomy Regulation), Regulation (EU) 2019/2088 (the Disclosure Regulation) and the amendments to various existing sectoral directives, including AIFMD and MIFID relating to the integration of sustainability into existing organisational rules and conduct of business rules.

The Taxonomy Regulation came into force in July 2020 and is expected to apply from December 2021. With the primary aim of reducing 'greenwashing', the Taxonomy Regulation provides a framework or 'taxonomy' for a pan-European classification system for environmentally sustainable economic activities, which will allow investors to identify and compare the sustainability credentials of relevant asset managers. The key obligation under the Taxonomy Regulation is that if a manager is deemed to be within scope, it will need to provide pre-contractual and periodic reports on if and how a fund, and its underlying investments meet the criteria for environmental sustainability under the Taxonomy Regulation. The Taxonomy Regulation is still evolving, and will be developed further by delegated acts which will set out the technical screening criteria for each objective under the Taxonomy Regulation. The delegated acts are expected to be adopted in a phased manner in 2021 and 2022.

The Disclosure Regulation came into force in December 2019 and is expected to apply from March 2021. The Disclosure Regulation applies at the firm level (i.e., manager-related disclosures) and the level of the fund (i.e., product-related disclosures). At the level of the manager, firms are required to disclose on their websites and in pre-contractual disclosures, the manager's policies on the integration of 'sustainability risks' in its investment decision-making processes, whether the manger considers principal adverse impacts of its investment decisions and where relevant, provide information on how the manager's existing remuneration policy consistent with integration of sustainability risks. At the fund level, the manager is required to describe the manner in which sustainability risks are integrated, for each fund where the manager considers principal adverse impacts, then include information of how this is being considered and confirmation of making this information available through periodic reports. There are additional disclosure requirements for those funds that are considered to be 'promoting' an environmental, social or governance (ESG) characteristic or funds that have a sustainable objective. At present, there is still some uncertainty on how the Disclosure Regulations will apply to non-EU managers. Although the majority of new requirements relate to transparency, the new EU ESG regulation require managers to make strategic and policy decisions regarding their approach to ESG and will necessitate significant changes to existing data gathering processes.

ii Tax developments

One of the main fund structuring objectives is to ensure that the investors in the fund suffer no additional taxes as a result of investing through the fund rather than investing directly in the underlying assets. For this reason, private equity funds in the UK are typically established as limited partnerships so that they are viewed as transparent for most UK tax purposes and do not fall into tax and generate tax leakage at the fund entity level.

On the basis that the fund is treated as tax transparent, the characterisation of the receipts of the fund as income (e.g., interest or dividends) or capital (e.g., sale proceeds) should be preserved for UK-resident investors (and some other categories of investors – although this is jurisdiction-specific and on a case-by-case basis). While this means that withholding tax issues can arise without appropriate planning, it historically enabled UK-based investment executives to secure capital treatment for any carried interest. With a current difference in rates of up to 45 per cent (for income) against up to 28 per cent (for capital), securing such capital treatment is an important objective for most UK-resident carried interest holders. For those carried interest holders who are UK-resident but domiciled outside the UK, there is also the possibility to defer or keep the proceeds outside the purview of the UK tax regime with appropriate structuring (known as the 'remittance basis' of taxation), although this planning has been somewhat eroded in recent years (see further below).

However, there are several regimes in the UK that can treat at least part of a carried interest return as income rather than capital. These relate to: (1) disguised investment management fees (DIMF); (2) income-based carried interest (IBCI); and (3) employment-related securities (ERS).

The DIMF rules took effect from 6 April 2015 and, very broadly, are designed to ensure that individuals involved in the management of certain investment schemes are taxed on the receipt of management fees from investment funds as either trading income or employment income (in both cases, at rates currently of up to 47 per cent). The rules seek to address structures that would otherwise result in a portion of any management fees being taxed as investment returns in the hands of the individuals (often at capital gains tax rates or lower).

The IBCI rules took effect from 6 April 2016 and, if applicable, tax carried interest as DIMF trading income (as above) if it constitutes IBCI (as opposed to capital gains). In summary, the extent to which carried interest is IBCI depends on the average holding period of the underlying investments of the scheme that gives rise to the carried interest. There is currently an exclusion from the IBCI rules for carried interest that constitutes an employment-related security (see below).

The ERS rules (which, unlike the more recent DIMF and IBCI regimes, have existed since 2003) may bring profits on certain 'securities' into charge as employment-related earnings (and taxed at current rates of up to 47 per cent). Securities for these purposes include units in a collective investment scheme, which, under the ERS rules, include partnership interests in a carried interest partnership. Employment includes any former or prospective employment and includes 'office-holders' (which extends to directors). In addition, 'salaried members' of UK limited liability partnerships are also treated as employees for these purposes. However, the ERS rules may not be relevant to partners in a partnership (other than salaried members – as above – or partners who are also directors of companies within the fund structure or fund portfolio companies).

In addition to the DIMF and IBCI rules described above, further changes were made in 2015 to the way UK capital gains tax rules are applied to carried interest. From 8 July 2015, 'base cost shift' was abolished and a new minimum level of taxation imposed on carried interest. These changes were designed to ensure carried interest holders are taxed on their true economic gain – whereas historically base cost shift would have given certain carried interest holders deductions in excess of the sums actually given by them as consideration for the acquisition of the right to that carried interest. The effect of the rules is that all carried interest arising on or after 8 July 2015 is subject to a minimum level of taxation of 28 per cent. The rules do not, however, displace pre-existing income tax rules, so when carried interest comprises income amounts (e.g., interest, dividends), income tax is due (at rates of up to 45 per cent) as well as capital gains tax. Relief may be claimed to prevent double taxation, but particular care has to be taken with regard to UK-resident carry holders who are also US taxpayers to ensure double taxation between the UK and the United States does not arise. Consequently, it remains critical to ensure that, on first principles, carried interest retains the character of underlying returns in the form of capital gains, and that underlying capital returns are not reclassified as income.

The UK capital gains tax rate was reduced from 28 per cent to 20 per cent with effect from 6 April 2016, but this reduction does not apply to carried interest, which continues to be taxed at the 28 per cent rate.

From 6 April 2017, individuals who have been resident in the UK for 15 out of the past 20 years are deemed domiciled in the UK for all tax purposes, with the effect that the remittance basis of taxation referred to above is no longer available. Further, if an individual has a domicile of origin in the UK and subsequently leaves the UK, shedding that domicile (acquiring a domicile of choice somewhere else), the UK domicile of origin will resurrect itself on the individual returning to the UK and becoming UK-resident.

On the UK real estate side, new rules came into force in April 2019 bringing non-UK residents into the charge to UK capital gains tax on the disposal (both direct and indirect) of UK commercial real estate, which represents a significant change for funds (and their investors) investing in UK real estate.

More generally, the impact of the Organisation for Economic Co-operation and Development (OECD) base erosion and profit shifting (BEPS) project, and of the EU anti-abuse directives, ATAD I and ATAD II, is now being seen across many jurisdictions, particularly in the response to the BEPS treaty-abuse and anti-hybrid measures, in response to which the UK implemented detailed and far-reaching anti-hybrid rules with effect from

1 January 2017. Likewise, the ECJ *Danish* cases on the interpretation of beneficial ownership and abuse of rights have made a significant impact, from a withholding tax perspective, on most international fund structures and the flow of funds from EU subsidiaries ultimately to fund investors.[24]

Looking forward, there continues to be a number of developments and challenges. In the UK, a new and specific tax regime for asset holding companies in alternative fund structures is being consulted upon, and a review of the UK VAT treatment of management fees alongside a more general review of the UK funds regime covering tax and relevant areas of regulation are both underway. Internationally, the latest OECD 'BEPS 2.0'[25] initiative should not be underestimated, with the potential to change the global tax landscape significantly by altering how profits are allocated between jurisdictions (Pillar 1) and introducing a new globally coordinated regime for minimum tax and anti-base erosion measures (Pillar 2). The EU mandatory disclosure regime (or 'DAC6' as it is more commonly known), entered into effect in EU Member States on 25 June 2018, adding to compliance burdens. However, the scope of the UK rules implementing DAC6 were narrowed significantly following the signing of the EU–UK trade and cooperation agreement (as above) and the end of the Brexit transition period on 31 December 2020. In the UK, only 'cross-border arrangements' falling under the category D hallmark (broadly, those that have the effect of circumventing the OECD's Common Reporting Standard or obscuring beneficial ownership) will be reportable. This is intended to be a temporary measure while, during the course of 2021, the UK consults upon and introduces new legislation to implement mandatory reporting under the OECD Mandatory Disclosure Rules, at such point what is left of the UK rules implementing DAC6 are expected to be repealed. While this step significantly reduces the number of reportable arrangements in the UK, DAC6 reporting is now live in EU Member States such that procedures for information gathering and reporting should now be in place by affected parties.

IV OUTLOOK

Top-performing managers and those who are able to differentiate themselves in terms of strategy or sector expertise remain very well positioned for the foreseeable future. Investors have significant liquidity due to legacy funds having made healthy distributions in recent years. Having said this, while concerns regarding the 'denominator effect' of falling public market valuations have largely receded since the start of the covid-19 pandemic because of the sharp recovery in stock markets, this issue may re-emerge depending on the shape of the economic recovery in 2021. There continue to be a substantial number of challenged fundraisings, and those managers unable to sufficiently differentiate themselves by strategy, track record or unique selling point may have to adopt alternative strategies such as deal-by-deal financings, single investor mandates (including managed accounts) or bespoke or

24 *T Denmark and Y Denmark v. the Danish Ministry of Taxation* (joined Cases C-116/16 and C-117/16) and *N Luxembourg 1, X Denmark A/S, C Danmark I and Z Denmark ApS v. the Danish Ministry of Taxation* (joined Cases C-115/16, C-118/16, C-119/16 and C-299/16)).

25 Base Erosion and Profit Shifting Project – 'Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy' (May 2019) and 'Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy' (January 2020).

particularly investor-friendly economic terms, rather than simply benefit from rising asset prices. While a number of first-time fund managers have been successful in the current environment, the bar for entry is set high. Those managers able to differentiate themselves and that have strong relationships with limited partners are able to raise capital in accelerated time frames in a largely, if not completely, virtual environment, with a view to deploying capital across the coming economic cycle.

Other historic trends have also continued:

a Minority stakes in managers: the market for managers selling stakes in themselves to third parties has become part of the mainstream private equity industry. While investor sentiment remains mixed, with 45 per cent of investors believing that managers that sell stakes in themselves to third parties make them a less attractive investment partner, while 12 per cent see such activity as a positive, provided that managers are able to demonstrate continued alignment of interests with their investors, focusing particularly on issues surrounding the control and governance of the broader business (e.g., investment strategy), the challenges are not insurmountable.

b Liquidity solutions: secondaries, fund restructurings and recapitalisations are now entrenched in the industry as an established, adaptable and opportunistic firm or portfolio management tool. The 'GP-led' secondaries market in particular continues to grow, now representing 44 per cent of aggregate secondary deal volume,[26] with this market segment gaining particular momentum during the pandemic by allowing managers to delay exits of top-performing assets.[27] The pandemic, and the resultant immediate need for follow-on capital has also seen the continued development of more specialist liquidity and capital raising tools, such as 'NAV' facilities and preferred equity.[28]

The outlook for private equity fundraising in 2021 is, in the main, positive, notwithstanding the wider economic headwinds caused by the pandemic. This is driven by the large number of firms either planning to raise a fund or actively marketing one, with the fundraising cycle increasingly being led by the timing of these larger managers, and their target fund sizes, with the largest investors seeking to consolidate their relationships with 'brand name' managers. This is not say that investors are unwilling to invest in smaller funds – the 5 per cent best performing small funds (<US$300 million) out-perform the 5 per cent best performing large funds (>US$1 billion) by approximately 700 basis points – however, investor resources are finite in an area where manager selection is crucial (conversely to the above, the bottom 5 per cent of small funds (<US$300 million) trail the performance of the bottom 5 per cent of large funds (>US$1 billion) by over 1,000 basis points).[29] Accordingly, the managers of smaller funds must ensure that their marketing cuts through, with track record above all else remaining the key differentiator and outperformance a prerequisite for smaller managers to remain competitive in a market where the bifurcation of the fundraising market between smaller and larger managers remains prominent.

26 Global Secondary Market Review, January 2021, Greenhill

27 'How selling to yourself became private equity's go-to deal', *Financial Times*, 28 December 2020.

28 'Coronavirus triggers borrowing spree by private equity managers', *Financial Times*, 3 October 2020; 'Is preferred equity the COVID-19 crisis's white knight?', Private Funds CFO, 20 April 2020

29 'The Merits of Investing In the Lower Middle Market In Beer-Drinking Europe', State of the Market 2020, Evercore.

Part II

Investing

Chapter 1

ARGENTINA

Diego S Krischcautzky and María Laura Bolatti Cristofaro[1]

I OVERVIEW

Private equity activity in Argentina flourished in the 1990s when it received a large portion of the investments made in the Latin American region. However, at the beginning of the 2000s, the Argentine economy crashed after the failure of the convertibility plan when the local currency was pegged to the US dollar. Since then, the country dipped in and out of financial and economic crises, defaulted on its sovereign debt, settled with its creditors and by the end of the 2010s, found itself in a similar situation. In Argentina, politics and economic activity tend to be more intertwined than in other places, and they influence each other significantly, thus the economic ups and downs tend to be tied to, and more influenced by, domestic politics rather than by international events or cycles. As a result, M&A and private equity tend to slow in times of political or economic change or instability.

The year 2020 was, for Argentina as well as for the rest of the world, a very difficult one. However, the trailing structural weaknesses made the arrival of the first wave of the covid-19 pandemic particularly difficult. At the beginning of 2020, Argentina was already undergoing a deep economic crisis that had been in the making throughout the 2010s. After a slow recovery in 2016 and 2017, fuelled by a return to the international voluntary markets, the delay of structural reforms weakened the faith of lenders in Argentina's repayment capacity, which in turn led to a debt crisis and steep devaluation in 2018. The incumbent administration asked for support from the International Monetary Fund (IMF), which approved the largest loan it has ever granted (US$57 billion). The need for such a huge rescue worsened the crisis, which translated into two consecutive years of recession, high inflation, steep devaluation, unemployment growth and political uncertainty.

The new economic scenario led, in December 2019, to a change of administration led by Alberto Fernández and two-time former president Cristina Fernández de Kirchner. It was clear by then that Argentina had to restructure its sovereign debt and the terms of the IMF loan.

The new government, inclined to a more interventionist approach, returned to heterodox economics policies, which led to many investors putting on hold their plans for Argentina until at least the sovereign debt was dealt with and the outline of a broad economic plan was unveiled.

While dealing with the problems described above, in early 2020 the covid-19 pandemic outbreak was initially deemed to be a faraway or less urgent problem, However, in March

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2020, Argentina documented its first covid-19 cases. With the confirmation that the virus had spread to the country, on 19 March 2020, the government established a strict lockdown that included restrictions on commerce and circulation, closure of borders, etc. and lasted, with some flexibilities, several months. The covid-19 pandemic significantly impacted an already dire Argentine economy, which shrank for the third consecutive year. In the meantime, the Argentine peso continued its slow but continuous depreciation against international currencies.

A combination of high inflation (36 per cent year-on-year), a trailing structural problem because of an endemic lack of confidence in the Argentine currency, and the steep decline in GDP (over 10 per cent) as a result of the covid-19 crisis has also led to a worsening of certain social indicators. As many countries around the world did, the Argentine government increased its spending exponentially to assist the most affected by the pandemic. The fiscal deficit of 2020–21 is expected to be the largest in 45 years.

On the bright side, in August 2020 the government finally managed to restructure the sovereign debt, avoiding an otherwise problematic default. It also began conversations with the IMF to negotiate a new programme for the upcoming maturities of the stand-by loan.

The fact that the prices of commodities are on an upward trend might also help the Argentine economy to enter into a recovery path in the upcoming months.

i Deal activity

The number of investments remained steady during 2019 on a year-on-year basis when considering private equity, entrepreneurship and seed capital transactions. As regards pure private equity deals, the number of transactions fell approximately by 65 per cent, while committed investments almost doubled, while venture capital (VC) remained most active as Argentina continues to be a dynamic tech hub and homeland for several landmark unicorns such as Mercadolibre and Globant.

The Argentine Association of Private Equity, Venture and Seed Capital (ARCAP) reported 92 private equity, entrepreneurship and seed capital deals during 2019 for a total investment of US$1.1283 billion. These figures include the acquisition by Advent International of the payment processing company Prisma Medios de Pago for US$724 million, which divestment from the prior owners (a group of local banks) was mandated by the Argentine Antitrust Commission, and the raising by fintech Ualá of US$150 million in a round led by SoftBank and Tencent, and by the commercial earth imaging company Satellogic of US$50 million to help scale up its satellite constellation.[2]

While full-year statistics are not yet available, ARCAP's report for the first semester of 2020 shows that there were no significant variations between the first part of 2018 and 2019 and the same period of 2020 in terms of number of private equity, entrepreneurship and seed capital transactions (i.e., 44, 45 and 43 respectively). However, committed capital significantly decreased when compared to the first semester of those years (i.e., US$445.5 million, US$891.1 million and US$41.6 million, respectively). The significant drop would be explained by the fact that during the first semesters of 2018 and 2019 there were extraordinary transactions for over-the-average amounts and because during the first semester of 2020, where the effect of the pandemic was beginning to be evident and the

2 www.businesswire.com/news/home/20191219005466/en/satellogic-announces-50m-funding-new-existing-investors.

stringency of the lockdown was the highest, there were no proper significant private equity investments (only entrepreneurship and seed capital) which usually involve transactions for higher amounts.

Industry news report at least some significant transactions in the second semester of 2020. These include the raising by the online travel agency Despegar.com of US$200 million in August 2020 through a private placement with L Catterton and an agreement with Waha Capital, an Abu Dhabi-based investment company, to issue and sell Series B preferred shares.[3] Other transactions are the raising by Autho, the most recent Argentine unicorn specialised in password authentication solutions, of US$120 million in June 2020, with investors such as Bessemer Venture Partners, Shappire Ventures, Meritech Capital, World Innovation Lab, Trinity Ventures, Telstra Ventures, K9 Ventures and DTCP participating in the rounds,[4] and the raising by Nuvemshop (also known as Tiendanube), an Argentina based e-commerce platform, of US$30 million in October 2020 led by KaszeK Ventures and Qualcomm Ventures.[5]

Private equity in Argentina is mainly driven by foreign (mostly regional) private equity firms and a relatively small number of local players. Local private equity firms are smaller in size than foreign private equity firms. Major international players such as TPG, KKR and Blackstone do not have significant direct presence. Riverwood Capital, Victoria Capital Partners and other major regional funds do have investments in local companies, although mostly with regional reach. The current political and economic context will likely result in a more active participation of local players in private equity transactions. This trend became apparent in many 2020 M&A transactions, including the purchase by Grupo de Narvaez of the Argentine business of Walmart in Argentina and the potential acquisition of Edenor, the largest electricity distributor in the country to a group of local investors.

ii Operation of the market

Management equity incentive arrangements in the local market follow international standards, in general. These include the payment of bonuses and the granting of stock option plans, restricted stock units or similar. Normally, and because of certain rigidities in the foreign exchange market, these incentives are a linked to a foreign issuer, which acts as a holder of the local company.

Sale processes in Argentina generally follow international practices. However, since Argentina's capital market is relatively underdeveloped, most of the transactions relate to the acquisition of unlisted companies or assets. Exits via IPOs or similar transactions are extremely rare.

After identifying the target, a due diligence process is normally conducted. The parties may or may not sign a letter of intent, memorandum of understanding or similar.

Once the due diligence is finalised, the transaction documents are negotiated. Transactions may be structured as share deals or asset deals. In the case of share deals, it has become increasingly common for purchasers to acquire at least part of the equity interests by

3 www.phocuswire.com/despegar-q2-2020-financial-report.

4 www.infotechnology.com/online/El-quinto-unicornio-argentino-ya-vale-US-2-000-M-y-gano-una-inversion-clave-de-un-gigante-de-EE-UU-20200715-0002.html#_ga=2.71752464.2010165046.1610914963-1055156295.1554301934.

5 https://lavca.org/2020/10/13/kaszek-and-qualcomm-lead-us30m-series-c-in-argentinas-e-commerce-platform-nuvemshop/.

making contributions in the target company for newly issued shares, rather than acquiring existing shares. This is usually because certain funds need to stay at the target entity level. The preferred structure will mainly depend on the parties' goals and a detailed case-by-case analysis of the efficiencies and inefficiencies of the different structures.

Transactions may also be envisioned with simultaneous or deferred signing and closing. This will usually depend on the conditions to closing that the parties may establish and any required prior consents to which the transaction could be subject either by law or contractually.

Having said this, depending on the industry in which the target operates, prior approval or post-closing filings may be required to implement the transaction.

Also, provided it entails a change of control, the transaction could be subject to merger control. There is currently a post-closing merger control system in Argentina. Therefore, if required, obtaining antitrust clearance is usually reflected as a post-closing obligation. Pursuant to a relatively recent amendment in applicable law, however, Argentina's merger control system should switch to a pre-closing system in the near future. In fact, a new bill has been submitted to the National Congress pursuant to which, if approved, the pre-closing system would become operative within 90 days.

In the case of listed target companies, the Capital Markets Law and the rules of the Argentine Securities Exchange Commission (CNV) will apply. Should the transaction entail a change of control in terms of the CNV rules, the purchaser will be required to issue a mandatory tender offer in favour of the remaining shareholders of the company, as provided in the CNV rules. In terms of mechanics, the tender offer needs to be launched immediately after a binding agreement is reached.

Asset transfers, if considered as the total or partial transfer of a business unit, will make the acquiring company jointly and severally liable with the seller for all pre-closing liabilities of the business. Likewise, asset deals are not different from share deals in terms of exposure to pre-closing liabilities. The Bulk Transfer Law and other regulations establish proceedings that, if fully followed, limit the successor company's liability for pre-closing periods (commercial liabilities and certain liabilities regarding federal taxes only). The Bulk Transfer Law proceeding entails publishing notices in favour of creditors and, if fully followed, notifying the Argentine tax authorities of the transfer. The fact that the publicity of the process may increase the seller's exposure and does not limit all pre-closing liabilities usually acts as a disincentive to follow the Bulk Transfer Law proceeding when solvency of the seller is not at stake or adequate guarantees are provided to the buyer.

II LEGAL FRAMEWORK

i Acquisition of control and minority interests

Private equity funds are not subject to a specific legal framework in Argentina. Neither are the acquisitions of control or minority interests, which are subject to the same rules applicable to any M&A transaction.

In general, for the reasons cited above, private equity firms, even when formed by Argentine residents, create foreign vehicles for investment outside Argentina (SPVs) in which they remain as general partners in charge of the administration, while incorporating limited partners. Investment and shareholders' agreements ruling the relationship between both types of partners are usually also subject to foreign law and jurisdiction.

Should the SPV be set up in Argentina, the relationship between the partners will be subject to the rules applicable to the investment vehicle form chosen by the parties and the terms of any shareholders' agreement in place. Because there are certain mandatory rules in Argentina for the different forms of vehicle, it is generally advisable that shareholders' agreements in these cases be governed by Argentine law.

The most frequently used corporate vehicles in Argentina are as follows:

a corporations (SA);

b sole shareholder corporations (SAU), which are very similar to SAs but can be set up by one shareholder only and are, therefore, subject to certain stricter rules;

c limited liability companies (SRL), which are sometimes preferred by US clients because they consider them as check-the-box entities; and, in the past couple of years

d simplified corporations (SAS), a new corporate type created in 2017 by the Entrepreneurship Law. SASs can be set up by one shareholder only, similar to SAUs, but were conceived as entities subject to less scrutiny from the registry, giving shareholders a greater degree of flexibility to set rules and lower maintenance costs. Recent regulations issued by the new authorities of the public registry of the city of Buenos Aires (IGJ) have, however, heavily increased control over SASs. In practice, these made SAS entities lose their distinctive comparative advantage.

Argentine law also includes partnerships limited by shares (SCA) within the corporate vehicles available. The SCA is the vehicle that better reflects the structure of private equity vehicles, as it distinguishes between partners in charge of the management of the vehicle (general partners) and mere equity partners (limited partners). However, in practice, this type of company is rarely used.

While in the case of SAs, SAUs, SRL and SASs, the general rule is that all partners limit their liability to the contributions made to the company, with limited exceptions (e.g., cases in which a judge may consider that there are reasons to pierce the corporate veil), in the case of the SCA, limited partners limit their liability to their contributions to the SCA, but general partners have unlimited liability for the company's operations.

To become a shareholder of a local corporate vehicle, a foreign entity would need to have previously appointed a representative in Argentina and registered with the public registry of the relevant Argentine jurisdiction (in the city of Buenos Aires, the IGJ) and with the Argentine federal tax authorities.

If the SPV is set up outside Argentina and subsequently acquires shares of an Argentine company, the SPV itself should have previously obtained those registrations.

Registering a foreign entity in the city of Buenos Aires may take some time because the IGJ requires foreign entities, among others, to provide evidence that their main corporate activities are conducted outside Argentina. While the former administration relaxed these requirements for a while, the new administration has reinstated prior regulations on this regard.

Argentine law does not generally restrict the acquisition of equity interests in Argentine companies by non-Argentine residents.

Despite this, as mentioned above, certain limitations, prior approvals or post-closing filings may exist in connection with certain industries. Also, restrictions may exist in connection with the acquisition by foreigners of rural or border lands, which would be analysed on a case-by-case basis depending on, among other things, the jurisdiction of the land within Argentina and the particularities of that jurisdiction.

In addition, while there is no prohibition to invest in Argentina from certain jurisdictions, foreign entities incorporated in jurisdictions considered as non-cooperative on fiscal transparency or in the fight against money laundering and terrorism financing will be subject to further scrutiny when submitting an application to register before the IGJ.

There are also some negative tax impacts associated with channelling investments in Argentine companies through a vehicle incorporated in any jurisdiction considered under the Income Tax Law as non-cooperative (i.e., any jurisdiction that has not entered into an information exchange agreement or a double taxation treaty (DTT) with Argentina or entered into any of the foregoing but does not comply with its obligation to share information) or in a nil or low tax jurisdiction (i.e., any country, jurisdiction dominium, territory, associated state or special tax regime in which the maximum corporate income tax rate is lower than 15 per cent). In principle, equity contributions in Argentine companies are tax neutral for the shareholder and the Argentine entity receiving the funds. However, the Argentine Tax Procedure Law sets forth a legal presumption by which incoming funds from non-cooperative or nil or low tax jurisdictions will be deemed to be an 'unjustified equity increase' on the Argentine entity, no matter the nature of the operation involved. Unjustified equity increases on the Argentine entity are subject to income tax and value added tax, and in both cases, the tax rates would be assessed on 110 per cent of the amount of funds transferred. Although Argentine entities receiving the funds may rebut such legal presumption, the standards required by the Argentine tax authority are difficult to meet.

In contrast, Argentina has entered into several double taxation treaties that could be beneficial for certain investors and should be taken into consideration when structuring a potential transaction (i.e., Australia, Belgium, Bolivia, Brazil, Canada, Chile, Denmark, Finland, France, Germany, Italy, Mexico, Norway, Russia, Spain, Sweden, Switzerland, The Netherlands, United Arab Emirates and the United Kingdom). Moreover, recently, the Argentine Executive Power has signed double taxation treaties with Austria, China, Japan, Luxembourg, Qatar and Turkey, but they are pending of approval by the Argentine Congress. In general, these treaties are based on the Organisation for Economic Co-operation and Development model. There is no DTT signed between Argentina and the United States.

Most of the private equity transactions in Argentina consist of the acquisition of non-listed entities, and transactions are implemented as per usual international terms. In terms of the transaction documents, the higher the interest acquired, the more bargaining power the purchaser will have. If acquiring control, the purchaser will be interested in reducing as much as possible the minority shareholders' rights after closing. If seeking a minority investment, the purchaser will seek to obtain as much control of the investment as possible, fixing aggravated majorities for certain sensitive matters, securing the appointment of a certain number of board members, etc.

In terms of governmental approval, transactions involving changes of control could be subject to merger control in Argentina, unless the transaction falls within any of the exemptions set forth under the Antitrust Law.

Also, the acquisition of control of public companies in terms of the Capital Markets Law and the CNV rules could make it necessary to follow a mandatory tender offer process, as mentioned in Section I.ii.

Whatever the percentage of shares of a local company acquired by the SPV, private equity firms usually pay special attention to exit provisions so as to ensure that the investment can be divested at a given time.

The most typical form of exit in Argentina is through a sale to a strategic investor. In the case of the investment in Prisma discussed in Section I.i, some local media conveyed that Advent International may be interested in exiting through an initial public offering, but this is not the most common practice. Reports show that private equity funds making investments in Argentina maintain their investments for an average term of 7.6 years.[6]

ii Fiduciary duties and liabilities

In general, pursuant to the Companies Law, directors are subject to a duty to act loyally towards the company and its shareholders and to carry out their functions with the diligence of a good businessperson. Should the SPV be set up in Argentina or if the SPV is set up abroad but appoints a director in an Argentine target entity, these standards will apply. The concept of loyalty embraces the obligation to meet the standard of an 'honest person' and to defend the interests of the company. In this sense, a director cannot compete with the company in furtherance of his or her own interest where such interest conflicts with the interest of the corporation. The good businessperson standard is applied to the particular circumstances of each activity undertaken by a director and is an objective standard. This standard requires, among other things, that directors possess certain qualifications (e.g., technical knowledge, expertise) and that they perform their responsibilities in accordance with such qualifications. Failure to meet the foregoing standards will make the directors unlimitedly and severally liable for any damage caused.

In addition, directors are personally and unlimitedly liable to the company, the shareholders and third parties for non-performance of their duties, violation of the law, by-laws or regulations, or for fraud, abuse of power or gross negligence.

Directors may also incur in liability under certain special regimes, such as under tax, labour, social security, customs, antitrust, banking, money laundering, bankruptcy, environmental and other laws and regulations.

III YEAR IN REVIEW

Recent deal activity

During 2018, 2019 and 2020, the hottest areas for private equity investment in Argentina were telecommunications, fintech and other areas of technology (i.e., Saas, E-Commerce, HealthTech, BioTech, AgTech, EdTech, Smartcity).

The biggest private equity transaction of the first part of 2019 was the acquisition of 51 per cent of Prisma Medios de Pago by the Boston-based private equity firm Advent International for US$724 million. Prisma is the leading payment company in Argentina and one of the largest in Latin America, operating in 15 countries, processing more than 7 billion transactions per year and hiring more than 1,300 individuals.[7]

The transaction was part of a divestment commitment undertaken by the shareholders of Prisma (14 banks and Visa Inc) in the context of an investigation initiated against them for monopolising the credit cards and electronic payment market.[8]

6 KPMG and ARCAP's report 'El Private Equity en Argentina 2010-2020'.

7 www.prnewswire.com/news-releases/advent-international-to-acquire-51-of-prisma-medios-de-pago-argentinas-leading-payments-company-300782256.html.

8 www.bloomberg.com/news/articles/2019-01-22/advent-buys-stake-in-argentine-visa-operator-for-725-million.

At the beginning of the process, bidders showed high interest in the company. However, the economic instability made some bidders lose interest. Certain local analysts have conveyed that the Prisma shareholders considered the valuation at which shares were sold as 'lacklustre' and that they would probably have waited for a better offer had they not had a deadline to divest by January 2019. In spite of this, Prisma's chief executive officer himself said that the deal was probably one of the largest equity transactions in Argentina in the past 30 years.[9]

As regards the economic terms of the transaction, according to public information, it was agreed that 60 per cent of the price would be paid at closing, while the balance will be paid within a five-year term, and that 70 per cent of the payment would be made in US dollars with the balance to be paid in Argentine pesos.[10] The deal included the granting of certain guarantees to secure payment of the deferred portion of the price.

In 2020, the most relevant private equity transaction would be Despegar.com.'s US$200 million raisings announced in tandem with the report of its financial results, which took a big hit from the covid-19 pandemic. As explained by CEO of the company, the capital raise shows the company's commitment to strengthen its balance sheet while allowing the company to grow through M&A transactions.

Because technology is one of the most attractive areas of investment for private equity, it is worth mentioning that the Argentine Congress created a Knowledge Economy Promotional Regime aiming at promoting economic activity that applies the use of knowledge and the digitalisation of information to obtain goods, provide services or improve processes. The regime granted certain tax and social security advantages to its beneficiaries.

While the initial regime was implemented during the former administration, this regime was abrogated by the current administration and a replaced by a new Knowledge Economy Promotional Regime. Although the new regime has undercut some of the benefits of the previous regime, it still provides interesting benefits for those qualifying under its terms.

As in the past regime, to qualify as part of the new Knowledge Economy Promotional Regime, companies must perform any of the promoted activities under the regime, register before the National Registry of Beneficiaries and meet at least two of the requirements set forth in the applicable regulations. The requirements include that the company performs continuous improvements in the quality of services, products or processes, invests in research and development activities for a certain period of time, or a certain minimum percentage (which will vary depending on the kind of activity and the beneficiary) of its exports of goods or services derive from the performance of any of the promoted activities.

Companies meeting at least two of these requirements will obtain certain tax benefits, including:

a fiscal stability in respect to the benefits granted under the regime;

b reduction of the general income tax rate, depending on the size of the company (60 per cent for micro and mini companies, 40 per cent for medium companies and 20 per cent for large companies) applicable on the gains derived from the performance of the promoted activities, and possibility of deducting for income tax purposes any amount paid abroad in concept of foreign taxes on the gains derived from the performance of the promoted activities;

c exemption from value added tax withholdings or collection; and

9 ibid.

10 ibid.

d tax credit bonus equivalent to 70 per cent of the social security contributions paid by the company in relation to employees affected to the promoted activities.

Each beneficiary must, however, pay an annual amount of up to 4 per cent per cent of the total tax benefits granted under the Trust Fund for the Development of Entrepreneurial Capital regime.

IV REGULATORY DEVELOPMENTS

No specific regulators have oversight of private equity transactions or firms in Argentina.

If the SPV or the target entity are incorporated in the city of Buenos Aires, the IGJ will, in principle, be the regulatory body with oversight of their operations. The role of the IGJ in potential transactions carried out by, or in connection with, registered local entities will depend on the type of vehicle involved. In the case of SA, SAU and SAS entities, for example, transfers of shares need not be filed with the IGJ. On the contrary, transfers of quotas of an SRL must be registered with the IGJ to become enforceable with regard to third parties. Periodical filings to be made with the IGJ will also vary depending on the corporate type.

Listed companies' activities are subject to the supervision of the CNV.

Depending on the industry in which the target entity operates, it may also be subject to supervision of other governmental bodies (e.g., insurance companies are subject to the supervision of the National Superintendence of Insurance). This may include the request of prior authorisation to close a transaction.

In all cases, the approval of the Antitrust Commission may be required if the transaction involves a change of control unless certain set exceptions apply.

V OUTLOOK

The uncertainties as regards the development of the covid-19 pandemic worldwide, and in Argentina in particular, and the country's economic situation will very likely slow down private equity activity during the first part of 2021.

However, times of crises have proven to be times of opportunity, particularly for private equity funds. Considering the economic and political context, we would expect more involvement of local players and investors than in previous years, as already evidenced by the latest M&A transactions.

In terms of transaction structures, the expectation would be that transactions in cash will include big discounts when compared with pre-crisis asset valuations. It is also expected that more transactions will include earnout schemes that permit the parties to share risks and align interests in light of the future development of the business. As regards the areas of investment, there will probably be a preference for industries with revenues in foreign currency with less exposure to currency devaluations, as well as in sectors where Argentina has shown sustainable competitive advantages. Upon consultation by ARCAP, investment funds reported that their main focus during the following 12 months would be in the technology and digital services, pharma and health, telecommunications and agrobusiness industries.

Chapter 2

AUSTRIA

Florian Cvak and Clemens Philipp Schindler[1]

I OVERVIEW

i Deal activity

General

Overall M&A activity posted a record low in 2020 as a result of the effects of the covid-19 pandemic. Majority deals declined by 25 per cent compared to 2019 and 33 per cent compared to the five-year average. With that, activity was even below levels from the peak of the financial crisis in 2009. While the first quarter showed a relatively modest decline of around 4 per cent, the following quarters showed declines of between 37 per cent and 26 per cent overall compared to 2019. Most closed transactions had a strategic element, at least in the large-cap segment, with the majority takeover of Borealis by OMV, to begin its transformation into a chemical business, being a perfect example. Domestic transactions (that is, transactions where the buyer and seller are based in Austria) even showed a slight increase compared to 2019 while cross-border transactions declined significantly. In terms of sectors, industrial and services, technology and finance did relatively well, while other segments showed more or less pronounced declines. Distressed M&A was not a factor so far, which is mainly a result of the state support programmes and covid-19-related insolvency legislation.

Inbound private equity activity also declined significantly, which was a result of almost all pending auctions being suspended until there was better visibility on the effects of the covid-19 pandemic on the business on sale. Also, with very few exceptions in Q4, no new auctions came to the market and on the other hand many players had to focus on stabilising their portfolios. Private equity activity picked up again at the beginning of Q4 but most of the deals that came to the market in Q4 have not yet closed and are thus not reported below. Of the (few) transactions that closed in 2020, most were either close to completion when the pandemic hit Austria at the end of Q1, resulted from pre-existing bilateral contacts or were completed in Q3 or Q4 and concerned unaffected businesses.

Buyouts

In the large-cap segment (comprising deals with values above €100 million), there was a sharp decline in deal count and total deal value of closed deals, with the acquisition by Royal DSM of Erber Group, an Austrian-based food and feed safety business (which also attracted significant interest by several private equity players (including EQT)), the acquisition by Apollo of a majority stake in Sazka Group, a Czech based gaming business holding (including

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an indirect majority stake in Austrian-based casino and lotteries business CASAG), and the acquisition of Austria-based cloud-based customer engagement platform Emarsys by SAP (which also attracted significant interest by major private equity houses before being ultimately sold to SAP) being the most prominent transactions.

In the mid-cap segment (comprising deals with values of between €10 million and €100 million), there was an even steeper decline in deal count and total deal value of closed deals compared to 2019. Examples of the few closed mid-market deals include the acquisition by Apollo-controlled Neuraxpharm of Austria-based consumer healthcare company Easypharm, the acquisition by Lafayete Mittelstand Capital of the elevator business of Gebauer & Griller Kabel und Metallwerke and the acquisition by VR Equity-controlled APZ of Ihr Autoputzmeister GmbH.

Venture and growth capital

Venture and growth capital activity (comprising deal values of €4 million and above) overall was less affected by the covid-19 pandemic. Examples of closed transactions include a large Series A financing round for Austrian-based fintech business Bitpanda led by New York-based Valar Ventures, a growth capital transaction led by Bregal for Austrian-based bicycle company Woom, as well as a smaller financing round for Austrian-based femtech startup Carbomed Medical Solutions led by aws Gründerfonds. In addition, there were several follow-on financing rounds and bridge financing rounds. Examples include Holo-Light, Playerhunter or Bonrepublic, to name a few.

Exits

In the large-cap segment (comprising deals with values above €100 million), apart from transactions already mentioned above, the only noteworthy completed exit was the sale by Ardian of its stake in Gantner Electronic Austria Holding GmbH, an Austria based access, ticketing and billing systems business, to SALTO Systems.

In the mid-cap segment (comprising deals with values of between €10 million and €100 million), notable exits included the sale by Bamberger Invest, SK Capital and management of Websms, an Austrian based messaging solutions company (which also attracted significant interest by private equity players), to Link Mobility, the sale of Austrian-based vaccine developer Themis to US pharmaceuticals company Merk & Co and the sale by aws of its stake in SIE Solutions (which also attracted significant interest by private equity players), an Austrian-based provider of embedded technology solutions to customers in healthcare and security industries, to Paramit Corp.

ii Operation of the market

In buyout transactions, a private equity firm often involves future management in the due diligence process and the financial modelling. Typically, management is required (or at least given the opportunity) to acquire an interest in the target to ensure their commitment; however, foreign investors often find that local management is not as familiar with such arrangements as would be the case in other jurisdictions. Second-level senior management is sometimes also given the opportunity to invest in the same instruments (known as the 'institutional strip') acquired by the private equity firm to ensure that their interests are fully aligned. In the latter case, structuring options are, by definition, limited. Where management is required (or given the opportunity) to participate on target level, share options (in the case of stock corporations), restricted shares (for a description of the typical restrictions, see below), profit participation rights (a contractual arrangement that can be structured as equity or debt and, by contrast to shares, never confers voting rights), virtual shares (that is, a contractual arrangement giving the member a stock-like return) and phantom stock (that is, a contractual arrangement giving the member a bonus depending on operational performance) are the most common structures.

The detailed structuring of incentive packages is usually driven by the tax treatment of the benefits in the jurisdiction of residence. For example, management will have a strong interest in ensuring that any gains in relation to interests acquired are taxed as capital gains (and not as employment income). In that context, it is important that economic ownership of the incentive interest passes at the time of the grant (which in Austria depends on the management members' entitlement to dividends (if any), voting rights and transfer restrictions). If economic ownership does not pass, the entire exit proceeds may be taxable as employment income. Management will typically also have an interest in limiting taxation at the time of the grant. Where economic ownership of the benefit concerned passes for arm's-length consideration (usually management is asked to invest up to one year's salary), there is no taxation of the grant (for Austrian tax residents). If there is no arm's-length consideration, the grant is taxed as employment income. Where the investor provides financing to the management, tax authorities may be more inclined to question whether economic ownership has passed for arm's-length consideration. Because the tax treatment of incentive programmes is often somewhat unclear, it is advisable to seek a tax ruling on the related tax issues before deciding on a particular incentive structure.

Where actual shares are held by management, they are usually pooled (e.g., through a partnership) so that the investor technically only has one co-investor, and they are restricted. Such restrictions typically include a drag-along right of the private equity firm upon an exit and compulsory transfer provisions if the employment with the target group terminates. The consideration due in the case of a compulsory transfer will typically depend on the reason for termination ('good' and 'bad' leaver provisions), although structuring has become less aggressive in that regard given recent developments in employment law.

Auction processes are relatively common on the Austrian market. A standard auction process will typically be organised by an investment bank (or M&A adviser). As a first step, the investment bank will propose a shortlist of potential bidders and discuss that shortlist with its client. The investment bank will then invite the selected bidders to submit an indicative bid on the basis of an information package (including limited commercial, financial and basic legal information about the target company). Following evaluation of the indicative bids, the investment bank will invite the most promising bidders to conduct Phase I due diligence, for a period of about two to six weeks, and to submit a binding bid (usually together with a markup to a sale and purchase agreement circulated in the middle of the Phase I due diligence). Following evaluation of the binding bids, the seller will engage in negotiations with two to three bidders, which are then granted access to the Phase II due diligence material and red files (if any). The time required for the entire process varies significantly depending on the appetite for the target and the number of bidders involved. It can range from as little as two to three months up to six months or even more.

II LEGAL FRAMEWORK

i Acquisition of control and minority interests

A typical acquisition structure for an Austrian private equity transaction involves a set of holding companies (holdcos) incorporated in Luxembourg, the Netherlands or another tax-favourable jurisdiction, and an Austrian acquisition vehicle (bidco) that enters into the purchase agreement and ultimately acquires the shares. The funds will typically try to maximise leverage on the transaction. Where junior debt (e.g., mezzanine) is used, senior lenders will often require junior lenders to lend to a level higher in the structure to achieve not only contractual subordination (which is achieved by entering into an intercreditor agreement) but also structural subordination. The gap between bank debt and the agreed purchase price is then financed by the fund through a combination of equity and institutional debt. The amount of institutional debt that can be deployed is determined by thin-cap rules. While the law does not provide any guidance in this respect, debt-to-equity ratios of 3:1 to 4:1 are generally accepted by Austrian tax authorities.

On or shortly after completion of the share purchase, the target company is usually asked to accede to the financing documents on an exclusive lender basis (to avoid structural subordination of the financing banks to existing lenders of the target company), and to grant guarantees and security interests securing the acquisition debt as well as refinanced target company debt (if any). To the extent such guarantees and security interests secure repayment of the acquisition debt, they are of little commercial value, as they are only valid to the extent:

a that the risk of default of the bidco and the risk of default of the target company (in cases where the security interest is enforced or the guarantee called) are acceptable, and that the granting of the security interest or guarantee will not put the target company at risk considering the risk of default of the bidco and the likelihood of recovery from the bidco based on the target company's recourse claims against the bidco, where the security interest is enforced or the guarantee is called; and

b the target company receives adequate consideration, which can either be a fee (in which case it should include a margin on top of the fee that would be charged by a bank in a comparable transaction) or an equivalent corporate benefit (e.g., access to financing that would otherwise not be available).

To preserve the validity of guarantees and security interests at least in part and avoid management (and supervisory) board liability, 'limitation language' is typically included in the financing documents that limits the obligations of Austrian obligors to an amount and terms that are compliant with Austrian capital maintenance rules.

At the same time, the private equity fund will seek to implement a tax offset structure, which is aimed at offsetting interest expense at the bidco level with profit generated at the target company level. In principle, there are two methods to achieve this. The first method is to establish a tax group between the bidco and the target company. In such a tax group, the fiscal result of the bidco and the target company is consolidated at bidco level. If the aggregated fiscal result of the bidco and the target company is negative, the loss can be carried forward by the bidco to future periods. The formation of such a tax group requires a tax allocation agreement and an application to the competent tax office. The required minimum period of a tax group is fulfilled when three full fiscal years have lapsed. If the tax group is collapsed prior to the lapse of the three-year period, the group members are retroactively taxed on a stand-alone basis. Austria introduced an interest barrier rule as of 1 January 2021 also applicable in the case of a tax group. A second method (which is sometimes discussed but rarely ever implemented because of the significant implementation risk it involves) is an upstream merger of the target company into the bidco. Based on past decisions of the Austrian Supreme Court, it is pretty clear that where the bidco carries the acquisition debt for the purchase of the shares of the target company, a downstream merger of the bidco into the target company will not be registered. In certain exceptional cases, however, an upstream merger of the target company into the bidco may be feasible. The result of such an upstream merger would be that the shares in the target company pass to the bidco parent, interest expense on the acquisition debt could be offset against profit, and guarantees and security interests granted by the merged entity (holding the cash-generating assets) would not be subject to limitations under the Austrian capital maintenance rules (see above) and thus would be of greater commercial value to the financing banks. In particular, the last point is often of great interest to the financing banks involved, which is why this route is sometimes explored when a particular case supports the necessary arguments.

In a buyout transaction, the key legal documents include the acquisition documents: that is, one or more share purchase agreements with the seller and the financing documents (including agreements governing equity contributions and institutional debt coming from the fund, a senior (and mezzanine) facility agreement governing the debt financing coming from the financing banks, security documents and an intercreditor agreement governing priority among the various layers of debt). In addition, where the fund does not acquire all the outstanding share capital, governance documents are required, including a shareholders' agreement, amended articles of association, and by-laws for the management board and supervisory board (if any). The main areas of concern in the governance documents are the fund's right to appoint sponsor representatives to the supervisory board (or an observer to the supervisory board, or both), sponsor representative liability (see Section II.ii), a list of matters requiring the consent of the fund or the sponsor representative (which should be tailored such that there is no undue influence on the day-to-day business), anti-dilution provisions, a liquidation preference for the fund, and information and exit rights for the fund.

In most cases, the fund will also insist that at least senior management enters into a management equity incentive arrangement (see Section I), and that the management and all key personnel enter into service agreements acceptable to the fund.

ii Fiduciary duties and liabilities

Duties owed by a shareholder

Austrian courts have consistently held that shareholders owe a duty of loyalty to the company and to other shareholders, requiring shareholders to consider the interests of the company and the interests of other shareholders in good faith and in line with *bonos mores*. As a general matter, the scope of the duty of loyalty is more pronounced for closely held companies than for widely held companies, and differs from shareholder to shareholder depending on the ability of the relevant shareholder to make a difference. A majority shareholder may, for instance, be exposed to liability for a failure to appear and vote on a matter under certain circumstances, whereas a minority shareholder will not because his or her appearance (or vote) is of no relevance to the outcome anyway. The duty of loyalty may require a shareholder to appear and approve a proposal of the management board where the implementation of the proposal is necessary for the survival of the company (e.g., a capital increase, a capital reduction or an asset sale in a restructuring). The duty of loyalty does not, however, require a shareholder to provide further financing to a company in financial distress.

A private equity fund shareholder must also consider his or her duty of loyalty at the time of exit. As a general matter, an exiting shareholder must account for the legitimate interests of the company and its shareholders when exiting his or her investment and prevent unnecessary harm (e.g., by excluding unpromising bidders, restricting competitors' access to sensitive information and ensuring confidentiality). Accordingly, it is important that a professional process is put in place that complies with these requirements.

The private equity fund should also be aware that, in considering the duty of loyalty, Austrian courts have discussed concepts similar to the 'corporate opportunities doctrine', which, in essence, provides that whenever an opportunity falls within the scope of activity of the company, a shareholder is prohibited from exploiting that opportunity for his or her own advantage.

A violation of duties of loyalty may result in claims for damages, cease-and-desist orders or a challenge of the shareholder vote that violates those duties.

Duties owed by members of the management and supervisory boards

As a general matter, all members of the management and the supervisory board (if any) of an Austrian company, including any sponsor representatives, owe to the company (not the shareholders or any other constituents) the following duties:

a a duty of care, requiring members to exercise the level of care of a proper and diligent person in similar circumstances (which includes an obligation to be reasonably informed and articulate any concerns they may have);

b a duty of loyalty, requiring members to act in the best interest of the company and its shareholders and not in their own interest;

c a duty of confidentiality; and

d in the case of members of the management, a duty not to compete. Supervisory board members are not explicitly prohibited from competing with the company, but any competition will always be subject to scrutiny under the duty of loyalty.

Where a member of the management or the supervisory board is at fault, he or she is jointly and severally liable for any damages incurred by the company with all the other members at fault, unless the shareholders' assembly has approved the measure resulting in the damage. A stock corporation may waive or settle its damage claims with an affirmative shareholder vote of 80 per cent after five years, or even before that with an affirmative vote of all shareholders. A limited liability company may waive or settle damage claims at any time, provided the waiver or settlement does not affect recovery against it by its creditors. A company may also take out directors and officers liability insurance for the members of the management board, in which case the associated expenses are treated as part of the remuneration of the relevant members.

A private equity fund should be aware that creditors of a joint-stock company (or, where insolvency proceedings have been opened, the administrator in those proceedings) can bring damages claims on behalf of the company against a member of the management or supervisory board to the extent that they cannot recover damages from the company in the following circumstances:

a where the claim is based on provisions protecting the proper pay-in of share capital (including liability for unpaid capital contributions and liability for an unpermitted return of capital) or because of unpermitted payments made during insolvency (also in cases of slight negligence); and

b in other cases, only where the relevant member was grossly negligent.

A waiver by the company or shareholder approval of the relevant measure does not exempt the fund from liability towards creditors (or the administrator).

Other sources of potential liability for the private equity fund involve:

a piercing the corporate veil, which is possible in the following circumstances:
   - factual management by a shareholder, or the exercise of control over the management board by a shareholder (where a shareholder, while not formally appointed, factually manages the company or substantially controls the management board);
   - undercapitalisation (only where there is an obvious imbalance between the risks of the business and the equity that is likely to result in a default of the company damaging creditors);
   - intermingling of assets (where, based on accounting records, the assets of the company cannot be separated from the assets of the shareholder); and
   - shareholder action putting the company at risk (where a shareholder takes action resulting in insolvency (e.g., acceleration of loans resulting in illiquidity or termination of a necessary patent));

b liability based on a breach of provisions protecting the proper pay-in of share capital (including liability for unpaid capital contributions, liability for unpermitted returns of capital and breach of financial assistance rules); and

c liability up to the amount secured where a shareholder has granted a guarantee or security interest securing a loan of a portfolio company in financial crisis (as defined in the Company Reorganisation Act), in which case the portfolio company can request the shareholder to pay to the creditor the amount secured for as long as it is in financial crisis (in which case, the recourse claim of the shareholder is suspended until the financial crisis is over). If the portfolio company pays the creditor, the portfolio company can request reimbursement from the shareholder.

III YEAR IN REVIEW

i Recent deal activity

See Section I.i.

ii Financing

The financing environment for buyout transactions more or less remained unchanged and is quite different for domestic market participants, who typically seek financing from domestic banks, and international financial sponsors, who are able to tap international banks (at least on large-cap deals). In the large-cap segment, debt-to-equity ratios are in the range of 50 to 60 per cent. In the mid-cap segment, debt-to-equity ratios tend to be more conservative, but this depends on the type of business acquired. Smaller deals are usually financed with equity only.

Where leverage is employed on mid-cap transactions, there is usually only senior and institutional debt, as adding junior debt tends to add another layer of complexity that is often not supported by the limited transaction size. On large-cap transactions, layers of junior debt are often added to the mix. High yield is of little significance in Austrian leveraged buyout practice as the time and cost involved tends to be disproportionate to the gains on the pricing side. With an increased relevance of debt funds, new financing structures are being employed more often.

iii Key terms of recent control transactions

See Section I.i.

iv Exits

See Section I.i.

IV REGULATORY DEVELOPMENTS

Domestic funds typically qualify as alternative investment funds (AIFs); as such, managers require a licence issued by the Austrian Financial Market Authority (FMA) under the Austrian Alternative Investment Manager Act (AIFMG). Most domestic funds qualify for the *de minimis* exception for managers of small AIFs with assets of less than €100 million (where leverage is used) or less than €500 million (where no leverage is used), and as such do not require a licence but are only required to register with the FMA. Another benefit is that they are only subject to a very limited number of regulations under the AIFMG.

Licensed AIFMs do not require any additional licences or permits for their investment activities. Registered AIFMs may require a trade permit for asset managers.

i Licensing processes

Licensed AIFMs

To obtain a licence under the AIFMG, managers need to fulfil certain requirements.

A licensed AIFM must have a minimum capital of €125,000 if it is an external manager of an AIF. If the AIFM is an internal manager of an AIF, the minimum capital requirement is €300,000. In addition, the AIFM must have sufficient equity to cover 25 per cent of its annual running costs. Increased equity requirements apply if the assets under management exceed €250 million; in any case, the maximum capital requirement is €10 million. The persons tasked with the management of the AIFM must be sufficiently experienced and must pass an FMA 'fit-and-proper' test if requested to do so.

The AIFM must appoint at least two individuals as its managers.

In the application to the FMA, the AIFM must provide information on:

a shareholders holding qualified participations in the AIFM (i.e., shareholdings exceeding 10 per cent);
b any closely related entities (i.e., a third party that holds a stake of more than 20 per cent of the AIFM or that controls the AIFM, or is controlled by the AIFM or in which the AIFM holds a stake of more than 20 per cent);
c its business plan;
d its remuneration, risk management, valuation, internal audit and conflict-of-interest policies;
e its investment strategies;
f a description of any competences delegated to third parties; and
g information on the contractual basis on which it manages its AIFs.

A decision by the FMA regarding the licence must be passed within three months of the applicant having provided all required information. If the AIFM intends to register an AIF as a European long-term investment fund, it has to apply to the FMA for prior approval.

Small AIFMs

Registered AIFMs may require a trade licence. A trade licence for asset managers requires an application to the competent trade authority. In making such an application, the AIFM has to prove that he or she employs in a management function a person that has the necessary qualifications to supervise the business operations of an asset manager (typically, a university education or practical experience, or both).

ii Ongoing obligations

Licensed AIFMs are subject to the disclosure requirements under the AIFMG, which require, inter alia, the submission of an annual report to the investors and the FMA, as well as the submission of a quarterly overview of all AIFs under management.

Under the terms of the trade licence, there are no material ongoing reporting obligations for small AIFMs (except that they have to report if a person in a management function mentioned in the application leaves the AIFM).

V OUTLOOK

The year 2021 promises to be a relatively busy one.

With better visibility on the effects of the pandemic, we expect several of the suspended auctions coming to the market. We also expect distressed M&A activity to play a significant role in 2021. Many businesses will have to undergo restructuring, which is always an opportunity for private equity investors, in particular, special situations funds but also generalist funds with a broader mandate. In terms of sectors, technology, industrial and services, as well as real estate, should be hot again. We expect venture and growth capital activity also to pick up again.

Chapter 3

CHINA

Julia Yu and Xiaoxi Lin[1]

I OVERVIEW

With the severe covid-19 impact in the beginning of 2020, private equity activity in China experienced a sharp lockdown dip in the first quarter of 2020. Responding to covid-19, a series of strict but effective epidemic preparedness and management measures were implemented by the Chinese authority, which turned out to be a success in the new pandemic reality. Corresponding to the effective epidemic control policies, private equity activity in China bounced back strongly in the second half of the year. In 2020, private equity investments in China increased substantially in terms of value, while the overall volume of the private equity deals remains the same level as last year. According to AVCJ Research, the market research division of *Asian Venture Capital Journal*, there were 2,048 private equity investments (of which 1,067 were publicly disclosed) with an aggregate investment amount of US$96.865 billion in China in 2020.[2] Compared with 2,106 investments with an aggregate amount invested of US$66.151 billion in 2019, the total volume of investments slightly decreased by 2.8 per cent and the total value substantially increased by 46.4 per cent in 2020. In 2020, private equity investments in China accounted for 48.2 per cent of the total value of private equity investments in the Asia-Pacific region, which brings China back to the most active private equity investment market in Asia-Pacific region.

The distribution among different investment types in 2020, compared with that in 2019, exhibited a substantial increase in the buyout investments (including management buyout, management buy-in, leverage buyout and turnaround or restructuring stages), a slight move up in the Private Investment in Public Equity (PIPE) financing, while a meaningful decline in expansion and growth-stage investments, a further decline in mezzanine and pre-initial public offering (IPO) stage investments, along with a slight drop in start-up and early stage investments. According to AVCJ Research, investments in buyout transactions increased from US$3.587 billion or 5.4 per cent of total investment value in 2019 to US$16.064 billion or 16.6 per cent of total investment value in 2020; investments in PIPE financing increased from US$9.880 billion or 14.9 per cent of total investment value in 2019 to US$18.918 billion or 19.5 per cent of total investment value in 2020; investments at expansion and growth stages still stayed ahead of other investment stages in terms of the value, at US$47.439 billion in

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2 As at 22 January 2021.

2020, while representing a meaningful drop in terms of the proportion, from 59.1 per cent of total investment value in 2019 to or 49.0 per cent of total investment value in 2020; investments at mezzanine and pre-IPO stages increased from US$8.626 billion in 2019 to US$8.821 billion in 2020; and investments at the start-up and early stages represented a smaller proportion of total investment value in 2020 than in 2019, dropping from 7.4 per cent of total investment value in 2019 to 5.7 per cent of total investment value in 2020.

The bumping up in private equity buyouts in 2020 was particularly noteworthy given the historical trend in that space since 2010. In general, buyout investments in China have remained relatively less frequent in comparison with many other jurisdictions. Buyout activities experienced an increase in 2010 and 2011, further strengthened in 2012 to 2014 amid the growing popularity of going-private transactions involving China-based companies, particularly companies listed in the United States, and boomed to be the bandwagon in 2015 as many US-listed Chinese companies received going-private proposals at the prospect of seeking a future listing on China's A-share market or the Hong Kong Stock Exchange. After experiencing a decline in 2016 and a short recovery in 2017, buyout activities in China hit a record low in 2018 and further dropped to the lowest point in history in 2019, and going-private activities were almost suspended. On 2 April 2020, along with a stunned attack by the short sellers, Luckin Coffee Inc (OTC: LKNCY), one of the hottest Chinese coffee brands, announced that it has initiated an internal investigation into certain information raised to the company's board's attention, which indicates that, beginning in the second quarter of 2019, Mr Jian Liu, the chief operating officer and a director of the company, and several employees reporting to him, had engaged in certain misconduct, including fabricating certain transactions. After a three-month internal investigation, the special committee has found that the fabrication of transactions began in April 2019 and that, as a result, the company's net revenue in 2019 was inflated by approximately 2.12 billion yuan (consisting of 0.25 billion yuan in the second quarter, 0.70 billion yuan in the third quarter, and 1.17 billion yuan in the fourth quarter). Following the internal investigation, the company is forced to contemplate the de-listing per the US Securities and Exchange Commission (SEC)'s request (the 'Luckin Event'). Given the materially adverse impact arising from the Luckin Event on the general reputation of the other China-oriented public companies as well as political factors between China and the rest of the world, buyout activities experienced a boom in 2020, which significantly surpassed the prior years. Based on statistics obtained through searches on the Thomson Reuters database Thomson ONE, of the 239 going-private transactions announced since 2010, 38 did not proceed and 161 have closed (12 closed in 2010, 16 closed in 2011, 24 closed in 2012, 26 closed in 2013, six closed in 2014, 28 closed in 2015, 17 closed in 2016, eight closed in 2017, two closed in 2018, 10 closed in 2019 and 12 closed in 2020). As at 31 December 2020, 28 going-private transactions were pending, including two announced in 2012, two announced in 2014, two announced in 2015, three announced in 2016, one announced in 2017, three announced in 2018, two announced in 2019 and 13 announced in 2020.

In respect of exits via IPOs, China undertook a moratorium on A-share IPOs from November 2012 to December 2013 and imposed another four-month moratorium on A-share IPOs in 2015. Following a strong recovery with a record number of successful IPOs in the Chinese domestic IPO market in 2016 and early 2017, the number of Chinese domestic IPOs dropped significantly at the end of 2017 until the second half of 2018 on account of tightened review standards, and a large number of IPO applications were queued. In part as a result of this large backlog, private equity-backed IPOs, an exit route heavily relied upon by China-focused private equity funds, experienced a dramatic decline in 2018, from 282 in 2017 to 93 in 2018, according to AVCJ Research. In 2019, China inaugurated its science and technology innovation board (Sci-tech Innovation Board), trying to kick off the country's much-anticipated capital market reform. To address private equity investors' concern on the potential backlog to list on the Sci-tech Innovation Board, China tried to implement a registration-based IPO regime on this new Board. With the newly launched Board, 202 Chinese enterprises accomplished A-share IPOs successfully in 2019 (including 70 companies that were successfully listed on the Sci-tech Innovation Board), which hits the highest watermark over the past five years. With that said, the number of private equity-backed IPOs decreased to 87 in 2019.[3] The reform of the listing system in China gradually delivered the optimistic confidence to the private equity investors in the domestic market in China. Following the trend, the number of private equity-backed IPOs hits 199 in 2020, which effectively doubled the number in 2019. On the other hand, exits via trade sales and secondary sales, accounting for 90.1 and 7.3 per cent, respectively, of private equity-backed exits in 2019, and 91.1 and 7.5 per cent, respectively, in 2019,[4] remained the dominant exit route for private equity funds in 2020 and are likely to maintain this position in the foreseeable future. The effects of the Sci-tech Innovation Board and the relevant reform policies thereof for private equity investors and their investments strategies in China are yet to be tested in the coming years.

In 2020, Chinese outbound M&A deal activity was hit by the covid-19 pandemic situation as well as political factors that together made cross-border deals very difficult, especially into developed markets such as the United States and European countries. As a result, the volume of Chinese outbound M&A deal activity declined to its lowest point from the record-hitting level seen in 2015. The covid-19 situation, the political and economic uncertainties within China and the rest of the world in 2020, heightened scrutiny over these transactions by the United States and certain European countries all leads to the decrease in the trend of Chinese outbound M&A deal activity. In addition, Chinese regulators have continually promulgated guidelines and policies on foreign exchange outflow control, and on the outbound target industries and channels for onshore financing affecting outbound investment activities, and have encouraged a more strategic and prudent approach in Chinese outbound investments. According to Thomson Reuters and PricewaterhouseCoopers analysis, in 2020, financial investor-backed Chinese outbound investments significantly decreased both in terms of volume and value, with 667 deals announced representing US$58 billion in 2019 and 403 deals announced representing US$42 billion in 2020. In addition, state-owned enterprise-backed Chinese outbound investments (which were historically the mainstream of the outbound investments in 2016) had steered their attention back to the domestic market, resulting in a very low value of investments overseas at only a tenth of the 2016 peak.

3 AVCJ Research.

4 ibid.

II LEGAL FRAMEWORK

i Investments through acquisition of control and minority interests

China's current Companies Law, which became effective on 1 January 2006 and was amended in 2013 and 2018 with effect from 26 October 2018, sets out the governance framework for the two types of Chinese companies: companies limited by shares and limited liability companies. A Chinese entity in which a non-Chinese investor owns an equity interest is called a foreign-invested enterprise (FIE), of which there are several types, including a wholly foreign-owned enterprise (WFOE), an equity or cooperative joint venture (EJV and CJV, respectively) and a foreign-invested company limited by shares.

To grant FIEs the same treatment in terms of corporate registration and other administrative procedures as Chinese domestic companies (to the extent possible and except where the principal business of the FIE falls within the scope of the Foreign Investment Negative List), China abolished a series of laws and regulations that had governed FIEs in the past and further adopted a completely new regime in favour of non-Chinese investors in 2019. Since 1 January 2020, FIEs have been subject to the Companies Law, the Foreign Investment Law (FIL), which was promulgated on 15 March 2019 and became effective on 1 January 2020, and the Regulation on the Implementation of the Foreign Investment Law (the FIL Implementation Regulation), which was promulgated on 26 December 2019 and became effective on 1 January 2020. The Regulations on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors (the M&A Rules), jointly issued by six governmental agencies in 2006 and amended in 2009, establish a general legal framework under which non-Chinese investors can acquire the equity or assets of Chinese companies subject to regulatory approvals. However, through a series of amendments to various regulations between 2016 and 2019, the regulatory approvals established by the M&A Rules are, in practice, no longer required; instead, there is a notification regime in place for FIEs. This notification regime took effect on the same date as the FIL and the FIL Implementation Regulation became effective (i.e., 1 January 2020) and shall be applied with respect to the incorporation, dissolution and change of corporate registration information of FIEs, as well as the general mergers and acquisitions made by foreign investors in a Chinese entity, provided that the transaction does not trigger 'special management measures for foreign investment access' under the Special Administrative Measures (Negative List) for the Access of Foreign Investment (the Foreign Investment Negative List) (as discussed below). In practice, the notification regime is integrated as part of the regular online registration procedure with the State Administration of Market Regulation (SAMR, the company registry agency that records all corporate registration information of legal entities incorporated under Chinese laws, whether domestic companies or FIEs). See Section IV for a detailed introduction of the FIL and the FIL Implementation Regulation.

Regulatory regimes applicable to foreign investments

An acquisition of or investment in a Chinese entity by a non-Chinese investor is subject to a multilayered government approval, information-reporting filing and registration process. Subject to the recent developments in respect of the information-reporting regime applicable to FIEs (see Section IV.i), the highest level of scrutiny is applicable to onshore investments (that is, direct acquisitions of equity in Chinese companies by a non-Chinese investor), which require the applicable project-based approval of the National Development and Reform Commission (NDRC) or its local counterpart, and the approval by, or information reporting to, central Ministry of Commerce (MOFCOM) if the size of a greenfield investment or the total investment amount of a target company whose business is in the industries specified in the Foreign Investment Negative List (as discussed below) exceeds US$1 billion, or MOFCOM's local counterpart if the size of the investment falls below US$1 billion but the target's business still falls within the industries specified in the Foreign Investment Negative List. Approval at the local level can typically be obtained within one month, but approval from central MOFCOM and NDRC often takes several months or longer. If a transaction is subject to an antitrust or national security review, as discussed below, MOFCOM or its local counterpart will typically defer review until the antitrust or national security reviews are completed.

Whether MOFCOM and NDRC will grant approval for a restricted transaction depends in part on whether the type of the underlying acquisition target falls within the scope of the Foreign Investment Negative List, jointly published annually by MOFCOM and NDRC (with the latest edition published on 23 June 2020 and effective from 23 July 2020), which lists the industries where special management measures for foreign investment access are applicable. The Foreign Investment Negative List partially replaces the former Catalogue for the Guidance of Foreign Investment Industries (the Foreign Investment Catalogue), and instead of grouping industries for foreign investment into 'encouraged', 'prohibited' and 'restricted' categories as the Foreign Investment Catalogue did, the Foreign Investment Negative List specifies only two categories of industries: industries in which foreign investment is prohibited and industries in which foreign investment is allowed with certain investment restrictions. Industries not mentioned by the Foreign Investment Negative List are deemed 'permitted' (i.e., not subject to the special management measures for foreign investment access). On 27 December 2020, NDRC and MOFCOM promulgated the Catalogue of Encouraged Industries for Foreign Investment (2020) (the Catalogue of Encouraged Industries), which became effective on 27 January 2021. The Catalogue of Encouraged Industries consists of two sub-catalogues (the list applicable to the entire country and the list applicable to China's central, western and north-eastern regions and Hainan province only). With the effectiveness of the Catalogue of Encouraged Industries and the latest Foreign Investment Negative List, the Foreign Investment Catalogue is now officially and entirely repealed. While a non-Chinese investor can acquire full ownership of a company in most encouraged and permitted sectors (and is often entitled to special advantages compared to domestic investors when acquiring a company in an encouraged sector), to invest in most sectors subject to the special management measures for foreign investment access (i.e., restricted industries), a non-Chinese investor is required to team up with a Chinese partner (and, in some cases, the Chinese partner must maintain a controlling stake). Investments by a non-Chinese party in a prohibited sector are typically prohibited.

In addition to these general approval requirements, foreign investments in several industries, such as construction and telecommunications, are subject to approval from the relevant Chinese regulatory authorities governing the applicable industries.

An indirect investment in China by way of an offshore investment in an offshore holding company that owns equity of an FIE is not subject to MOFCOM and NDRC approvals applicable to an onshore investment; however, both an onshore and an offshore investment may be subject to China's antitrust and national security review schemes.

The antitrust regime in China is established and governed by the Anti-Monopoly Law of the People's Republic of China (AML), which became effective on 1 August 2008. Under the AML, an antitrust filing with the SAMR anti-monopoly authority is required for any transaction involving a change of control if the sales in China in the prior accounting year of each of at least two of the parties involved exceeded 400 million yuan, and all of the parties' aggregate worldwide sales in the prior accounting year exceeded 10 billion yuan or the parties' aggregate sales in China in the prior accounting year exceeded 2 billion yuan. These monetary thresholds will remain unchanged until new ones are promulgated in an amendment to the AML; to date, there has been no amendment to these thresholds since 2008.

On 26 July 2019, SAMR published three new anti-monopoly regulations (the Interim Provisions on the Prohibition of Monopoly Agreements, the Interim Provisions on the Prohibition of the Abuse of Market Dominant Status and the Interim Provisions on Prevention of the Abuse of Administrative Power to Exclude or Restrict Competition as the guideline on enforcement of the AML). These three regulations became effective on 1 September 2019. On 2 January 2020, SAMR further released a draft of the amendment to the Anti-Monopoly Law (the Draft AML) for public comment. The Draft AML imposes harsher penalties on monopolistic conduct and proposes to increase the maximum fine for monopolistic agreements from 500,000 yuan to 50 million yuan. The Draft AML also introduces criminal liabilities for individuals engaged in monopolistic conduct for the first time. The definition and scope of monopolistic agreements have been expanded to include 'hub-and-spoke' arrangements. In addition, SAMR will have greater flexibility in merger reviews by tolling the statutory timeline, reaching a wider range of deals and revoking previous decisions on the basis of false or inaccurate information under the Draft AML. The Draft AML will be subject to various rounds of review and comments before it can be officially adopted and may be further revised during the review process; it is, therefore, unclear whether and when the above changes will become binding law.

In February 2011, China's State Council issued Circular 6, which established a national security review scheme for the acquisition of a Chinese business by one or more non-Chinese investors. Two broad transaction types are subject to Circular 6 review:

a the 'acquisition' of any stake (regardless of the size) in a military enterprise, a supplier to a military enterprise, a company located near sensitive military facilities or any other company relating to national defence; and

b the acquisition involving 'control' of a Chinese company whose business involves 'key' agricultural products, energy and resources, infrastructure, transportation services or technologies or manufacturing of equipment and machinery 'affecting national security'.

In April 2015, the General Office of the State Council issued the Tentative Measures for the National Security Review of Foreign Investment in Pilot Free Trade Zones, which took effect in May 2015 (the Tentative Measures). Under the Tentative Measures, the national security review extends to foreign investment in important culture and information technology products sectors that are vital to national security and in which foreign investors have de facto control over the invested entities. The types of foreign investments regulated by these Tentative Measures include sole proprietorship, joint venture, equity or asset acquisition, control by contractual arrangements, nominal holding of interests, trust, re-investment, offshore transactions, leasehold and subscription of convertible bonds.

Both China's antitrust and national security review schemes provide Chinese authorities with wide discretion to determine whether a transaction is subject to review and, if subject to review, whether it should be blocked. Under Circular 6, the meanings of 'key' and 'affecting national security' are undefined. Provisions issued by MOFCOM in 2011 to implement

Circular 6 prohibit an investor from circumventing the national security review by structuring a transaction by way of nominee arrangement, trust, multilayered re-investment, lease, loan, contractual control, offshore transaction or other such structuring. Under both the AML and Circular 6 and other regulations regarding antitrust or national security review, control is defined broadly and includes having voting rights sufficient to exercise a major impact on board or shareholder resolutions, particularly with respect to key business or operational decisions. As such, private equity investments involving certain customary protections (e.g., veto rights, supermajority voting requirements and negative covenants) could arguably be interpreted to involve control under both statutes. If there is ambiguity as to whether a filing is required, it is usually prudent for an investor to make a filing to avoid adverse consequences later. After SAMR was established and assumed responsibility for antitrust filing matters, the State Council issued revised guidelines on antitrust filings in September 2018, which are not substantially different from the original guidelines and have simply changed the relevant regulatory authority's name and where the relevant party should submit the filing. Prior to this 2018 version, the 2014 revised guidelines attempted to clarify the moderately controversial concept of control in the context of antitrust filings and provided for a formal pre-filing consultation with the Anti-Monopoly Bureau of MOFCOM (changed to the Anti-Monopoly Bureau of the State Administration of Market Regulation in the 2018 guidelines) for investors, to assist them in determining whether a filing would be triggered. If a transaction is subject to national security or antitrust review, the anti-monopoly authority will conduct a policy-driven review to determine whether the transaction can proceed unimpededly: it considers not only the effect of a transaction on national security or competition, as applicable, but also takes into account its effect on public interest and the stability of the national economy and social order, as well as the views of industry associations and other market participants.

In addition, the FIL has set out the principle that the Chinese government shall establish a national security review of foreign investment without specifying the details.

On 19 December 2020, NDRC and MOFCOM jointly issued the Measures on Security Review of Foreign Investment, which took effect on 18 January 2021 (the Security Review Measures). The Security Review Measures amend the previous review framework stipulated by the Tentative Measures and provide detailed rules to tackle the rising national security concerns and to address the global trend of strengthening national security review on foreign investment.

Further, the M&A Rules contain, in effect, a restriction on 'round-trip' investments by requiring MOFCOM approval for any acquisition of a Chinese company by an offshore company formed or controlled by any Chinese entity or individual affiliated with the Chinese target company. Typically, this approval is not granted. Where the offshore structure was in place prior to the adoption of the M&A Rules in 2006, however, the acquisition of a Chinese target by the offshore entity may still be permitted.

Governance of and exit from onshore joint ventures

Since the FIL became effective, all FIEs are regulated pursuant to the Companies Law, the FIL and the FIL Implementation Regulation, which enables foreign shareholders in an FIE to more easily obtain or enforce certain contractual rights that are considered fundamental for private equity investors in other jurisdictions, including rights pertaining to governance and exit, compared with the old regulatory framework that applied to FIEs before the adoption of the FIL, as some previous onerous requirements on corporate governance of FIEs have been abolished (e.g., for Chinese–foreign EJVs, certain key corporate actions required unanimous approval by the board; a Chinese partner typically had the right to appoint at least one director, which basically gave the Chinese partner certain veto rights regardless of its shareholding percentage).

If the Chinese shareholder is a state-owned enterprise (SOE), enforcement may be a bit difficult, as a transfer of an SOE's interest in a joint venture is subject to a statutory appraisal and an open bidding procedure, unless waived by the appropriate authorities. Regardless of what rights may be contained in a joint venture contract, a local Chinese court injunction granting specific performance against a Chinese shareholder and in favour of a foreign investor is far from certain.

Implications of the regulatory framework on a transaction structure

To avoid the requirements of obtaining NDRC and MOFCOM approval and to enhance structuring flexibility, foreign private equity investors typically prefer to invest in China through an offshore investment. The ideal transaction structure, when feasible, is that the foreign investor invests alongside a Chinese partner in an offshore Cayman Islands or British Virgin Islands company, with the company owning 100 per cent of a Chinese WFOE (often indirectly through a Hong Kong entity, to obtain preferential treatment on dividends). This structure also allows the foreign investor to benefit from transaction agreements governed by foreign laws and to avoid the need to enforce its rights in China. Because of foreign ownership limitations and the prohibition on round-trip investments, however, this offshore structure is seldom available for foreign investments in Chinese targets that have not formed an offshore holding structure prior to the effectiveness of the M&A Rules.

Many non-Chinese investors use a 'variable interest entity' (VIE) structure to invest (indirectly) in China to avoid seeking certain Chinese regulatory approvals (approvals that will not or will not be expected to be granted to FIEs). Under a VIE structure, Chinese individuals, often the founders, key management members or their relatives, are the registered shareholders of a domestic operating company, which holds the required licences and permits needed for the business to operate. An investor (often in conjunction with the founders) then forms a WFOE through an offshore entity it owns, and the WFOE enters into a series of contractual arrangements with the operating company and its registered shareholders pursuant to which the WFOE obtains control and an economic interest in the operating company. These contractual arrangements can take many forms, but often include an exclusive service or licence agreement, a voting proxy agreement, a share pledge agreement and a loan agreement, and an exclusive option agreement (together with a form of equity transfer agreement) allowing the WFOE (when permitted by Chinese law) or its appropriate affiliates or designees to acquire the equity interests or assets of the operating company. Commentators frequently note that the VIE structure is legally risky given that it arguably violates the spirit (if not the explicit text) of Chinese regulations; however, Chinese companies, including some of the large public companies, such as Alibaba, Baidu and Tencent, continue to use this structure.

The FIL and the FIL Implementation Regulation chose to remain silent on the topic of VIE. It is understandable that, given the large number of enterprises currently adopting the VIE structure, the potential impact of changing the status quo may be significant and unpredictable. Notably, the FIL provides that foreign investment includes the circumstance where a foreign investor acquires shares, equities, property shares or any other 'similar rights and interests' of an enterprise within the territory of China. 'Similar rights' is a term broad enough to include interests derived from a VIE structure. It not only affords companies enough room to manoeuvre but also gives the government ground to assert jurisdiction over the VIE structure when the time is right. Given the continuous reform in and opening up of China and the decrease in foreign investment restrictions, it will come as no surprise if the Chinese government decides to deal with VIE structures in the future when this issue is ripe for resolution.

ii Fiduciary duties and liability

Fiduciary duties and potential liabilities of directors, officers and supervisors under Chinese law

The Companies Law is the primary statute regulating the actions and duties of directors, officers and supervisors of a Chinese company. Pursuant to the Companies Law, a director, officer or supervisor must abide by the laws, administrative regulations and articles of association of the company, and has duties of loyalty and care to the company. Similar to many other countries, a breach of duty by a director, officer or supervisor of a Chinese company may give rise to civil, administrative or criminal liability. A particular concern to a private equity investor in China, however, is that a director, officer or supervisor may be liable for criminal liability not only for his or her own wrongdoing, but also for crimes committed by the company if he or she is the 'manager directly in charge' or 'person directly responsible' for the management of the matter with respect to which a specific criminal act was committed by the company. This risk of personal liability for company wrongdoing is more acute for a director or officer who is also the chairperson of the board, executive director or legal representative of the company or who otherwise serves in a senior management capacity, such as a general manager or chief financial officer. Often by way of seeking to ensure that their representatives are not assigned responsibility for any specific matters, most non-Chinese private equity funds are comfortable appointing their representatives to the boards of Chinese companies, despite the risk of liability. While directors' and officers' insurance and indemnification agreements may protect against civil liability, many types of administrative or criminal liability cannot be mitigated by insurance and indemnification.

Chinese tax exposure

Since January 2008, China's Enterprise Income Tax Law (the EIT Law) has imposed a 10 per cent capital gains tax on the sale of a domestic Chinese company by a foreign investor. On 3 February 2015, the State Administration of Taxation of the People's Republic of China (PRC) issued Circular (2015) No. 7 (Circular 7) on Chinese corporate income tax treatments of indirect transfers of Chinese assets (including equity interest in a Chinese company) by non-resident enterprises. Under Circular 7, an indirect equity transfer of a Chinese entity by an offshore seller (such as selling the equity of an offshore holding company) that does not have a reasonable commercial purpose and that is structured to avoid applicable Chinese taxes will be re-characterised by the Chinese tax authorities as a direct equity transfer of the Chinese entity for Chinese tax purposes, and the offshore seller will be required to pay capital gains tax for the transaction. Although it is within the discretion of the parties to such offshore transactions to determine whether to make a Circular 7 filing to report the offshore transaction for the Chinese tax authorities' assessment for Chinese tax purposes, Circular 7 employs a penalty structure designed to motivate parties to offshore transactions involving indirect sales of Chinese companies to report potentially taxable transactions to the Chinese tax authorities. Because of the uncertainty under the Circular 7 regime regarding what will satisfy the Chinese tax authorities as a non-tax-avoidance justification with reasonable commercial purpose for the offshore sale of Chinese entities, and regarding the evolving market practice with respect to these matters, many practitioners interpret the application of Circular 7 in a broad way and recommend making Circular 7 filings to reduce the risks and potential penalties for evading Chinese tax obligations.

An offshore vehicle established by a non-Chinese private equity investor to make an investment in a Chinese company will be treated as a 'PRC-resident enterprise' under the EIT Law, and will be subject to a flat 25 per cent enterprise income tax on its worldwide income if the offshore vehicle's de facto management body is in China. Although the language of law is unclear, factors that the State Administration of Taxation may take into account in determining tax residency include whether:

a the offshore vehicle locates its senior management and core management departments in charge of daily operations in China;

b financial and human resources decisions of the offshore vehicle are subject to determination or approval by individuals or bodies in China;

c the offshore vehicle's major assets, accounting books, company seals, and minutes and files of board and shareholders' meetings, are kept or located in China; and

d at least half of the offshore vehicle's directors or senior management reside in China.

To mitigate the risk that any dividends, sale proceeds or other income received by an offshore vehicle might be subject to this tax, an offshore vehicle should take steps to establish that it is not effectively managed and controlled in China.

SEC enforcement actions

Several notable developments in the SEC's enforcement of the Foreign Corrupt Practices Act (FCPA) occurred in 2020. In particular, on 3 July 2020, the US Department of Justice (DOJ) and SEC issued the second edition of the official FCPA Resource Guide (the 'Second Edition Guide'), affirming that FCPA enforcement remains a government priority. The Second Edition Guide incorporates key policies promulgated by the DOJ in recent years, including the FCPA corporate enforcement policy, the policy on coordination of corporate resolution penalties, the selection of monitors in Criminal Division matters, and the evaluation of corporate compliance programmes. Additionally, the DOJ issued an updated guidance regarding corporate compliance programmes on 1 June 2020 that underscored the US government's continued focus on the importance of implementing a compliance programme that goes beyond paper policies and can be adapted to suit a company's emerging risks.

The year 2020 marked another busy year in FCPA enforcement actions. In 2020, US authorities (including the SEC and DOJ) brought FCPA enforcement actions against 12 companies and imposed financial penalties totalling a record US$6.4 billion, over two times the total penalties recovered in 2019. FCPA-related penalties in 2020 ranged from Goldman Sachs's US$3.3 billion settlement (largest) to Cardinal Health's US$8.8 million (smallest).

While China has been a focal point of FCPA enforcement activities for the past decade, FCPA enforcement cases involving China decreased slightly in 2020. Of the FCPA enforcement cases brought by the SEC in 2020, only three involved activities by multinational companies and their subsidiaries in China. In comparison, in 2019, there were seven cases brought by the SEC that had links to China. That said, this slight drop in cases touching China is unlikely to signal that the US regulators have shifted their attention away from China.

The three FCPA enforcement cases involving China are as follows.

a In August 2020, Herbalife Nutrition, Ltd, a Los Angeles-based direct selling company, agreed to pay a total of US$123 million in fines and disgorgement to the SEC and DOJ to settle charges that it violated the books and records and internal controls provisions of the FCPA. The government's charges arose from an alleged bribery scheme orchestrated by Herbalife's Chinese subsidiaries. Specifically, the company allegedly conspired with its subsidiaries in China and others to falsify its books and records, and allegedly provided extensive and systematic corrupt payments to Chinese government officials over a 10-year period to promote its business in China.

b In June 2020, Novartis AG, a global pharmaceutical and healthcare company, and its former subsidiary Alcon, agreed to pay over US$340 million in fines and disgorgement to resolve SEC and DOJ charges arising out of alleged misconduct in multiple jurisdictions. Specifically, the company allegedly made improper payments to public and private healthcare professionals in exchange for prescriptions and lacked sufficient internal accounting controls in one of its China subsidiaries, which used forged contracts as part of local financing arrangements.

c In February 2020, Cardinal Health, an Ohio-based pharmaceutical company, agreed to pay US$8.8 million to settle SEC charges that it violated the books and records and internal controls provisions of the FCPA in connection with its operations in China. Cardinal entered the China market by acquiring the Chinese subsidiaries of an established pharmaceutical company and rebranded the acquired entities as 'Cardinal China' after the acquisition. According to the SEC, Cardinal Health's Chinese subsidiary retained thousands of employees and managed two large marketing accounts on behalf of a European supplier between 2010 and 2016 without putting in place proper anti-corruption controls. Certain China-based employees allegedly directed marketing funds to government-employed healthcare professionals and employees of state-owned enterprises. The SEC claimed that Cardinal Health did not apply sufficient accounting controls to detect these improper payments and failed to maintain complete and accurate books and records with regard to the aforementioned marketing accounts.

In 2020, the US government continued to pursue enforcement actions under the FCPA against individuals, including Chinese nationals. In November 2019, as part of the enforcement action against Herbalife, the US government disclosed civil and criminal charges against Jerry Li (a Chinese national and the former managing director of Herbalife) for alleged FCPA violations. The SEC alleged that Li orchestrated a scheme to bribe Chinese government officials to obtain direct selling licences and curtailed a government investigation of his company's business practices in China. The DOJ filed criminal charges against Li and Mary Yang, who formerly ran the external affairs department of Herbalife's China subsidiary, for reimbursing more than US$25 million in entertainment and gifts provided to Chinese government officials between 2007 and 2016. Significantly, the DOJ alleged that Li intentionally lied to government enforcement officials in the United States and attempted to destroy documents relevant to their investigation.

Chinese authorities' enforcement actions

In addition to scrutiny from US regulators, multinational companies and private equity firms also face potential enforcement risks by the Chinese anti-corruption and antitrust authorities.

Chinese anti-corruption enforcement update

The number of anti-corruption enforcement actions by Chinese regulators targeting unfair competitive conduct has declined in 2020. This decline may be attributed in part to the impact of the covid-19 pandemic in China. However, anti-corruption enforcement remains a top priority for Chinese authorities. For example, in December 2020, the National People's Congress promulgated amendments to the Criminal Law of the People's Republic of China, which increased the maximum criminal penalties to life imprisonment for private individuals convicted of commercial bribery, embezzlement and graft of corporate assets and funds. This amendment imposes penalties on private individuals on a par with penalties imposed on government officials found guilty of similar misconduct. In October 2020, the Shanghai government issued a revised version of its Regulations of Anti-Unfair Competition (the 'Shanghai Regulations'), which became effective on 1 January 2021. The Shanghai Regulations require a company to enhance its internal controls and compliance programme. This is the first regulation in China that specifically references 'compliance programme'. Under the Shanghai Regulations, companies are encouraged to establish and refine their anti-unfair competition (e.g., anti-commercial bribery) compliance system, the implementation of which will be evaluated by government authorities during bribery probes.

Chinese antitrust enforcement update

China's antitrust enforcement framework took a major leap in 2020, including a proposal to amend the Anti-Monopoly Law and the draft rules on the platform economy. Specifically, in January 2020, the State Administration for Market Regulation (SAMR), the government authority responsible for regulating a wide range of market activities from competition to food safety, published a draft amended Anti-Monopoly Law (the Draft AML) for public comment. The Draft AML proposes several key changes, including to drastically increase fines, especially for (1) failures to notify regarding mergers, acquisitions and joint ventures, (2) gun-jumping, and (3) breaches of merger conditions. The Draft AML law also introduces mechanisms to stop the review clock during merger control assessments by the SAMR. This is the first time China has proposed major changes to its centerpiece antitrust legislation since the Anti-Monopoly Law came into force in 2008. In November 2020, the SAMR also issued a draft of the Guidelines for Anti-monopoly in the Platform Economy for the purpose of regulating monopolistic behaviour in the platform economy.

In 2020, there is a notable trend towards heightened antitrust scrutiny of major technology companies in China. For example, In December 2020, the SAMR imposed a fine of 500,000 yuan on Alibaba Investment (for its investment in Intime Retail), China Literature (for its acquisition of New Classics Media) and Shenzhen Hive Box Network Technology (for its acquisition of China Post Logistics Technology), for failing to notify the SAMR of the respective transactions. This is the first time that the SAMR has fined transactions involving a VIE structure.

Separately, on 24 December 2020, the SAMR announced that it had opened an investigation into Alibaba Group Holding for suspected monopolistic conduct. The SAMR indicated that it launched the investigation following complaints received against Alibaba, and that it will target the practice described as 'choose one from two' that forces vendors to enter into exclusive sales contracts with Alibaba, as well as other unspecified issues. The investigation is ongoing.

Further, on 30 December 2020, the SAMR imposed a fine of 500,000 yuan on each of Beijing Jingdong Century Information Technology Co, Ltd (JD), Hangzhou Haochao E-commerce Co, Ltd (Tmall) and Guangzhou Vipshop E-commerce Co, Ltd (Vipshop) for price irregularities during the Singles' Day shopping festival. In particular, the SAMR found that these companies raised prices on certain goods to higher-than-normal levels prior to the shopping festival in order to mislead consumers. Although the size of the penalties are not large, they nevertheless signal that China's antitrust regulators are set to play a more active role in the technology and e-commerce sectors.

Antitrust enforcement in other traditional sectors shows no sign of slowing down in 2020. For instance, in April 2020, the SAMR imposed a significant fine of 325.50 million yuan on three distributors of Calcium Gluconate API for abuse of dominance. Specifically, the SAMR noted that the three distributors were collectively dominant as a group in the relevant market. Even though they were independent legal entities, the SAMR found that one of the distributors had control over the other two by way of personnel and financial connections, and its ability to make business decisions for all three. It is not entirely clear if the decision relied on the theory of collective dominance or whether the three distributors were treated as one undertaking. The three distributors allegedly sold products at unfairly high prices to downstream drug manufacturers, as determined by a price-cost comparison. They also allegedly imposed unfair transaction terms on downstream drug manufacturers by requiring them to exclusively sell final drug products back to the three distributors. The high penalty sets multiple records for antitrust enforcement in China, including the highest penalty for an antitrust violation and for obstructing antitrust enforcement. The record-high penalty underscores the importance of antitrust compliance in China.

iii Chinese outbound M&A

Chinese outbound investment approval and filing regimes

A proposed outbound investment in overseas target assets by a Chinese investor is subject to a series of outbound investment approval, filing and reporting requirements with competent Chinese authorities depending, inter alia, on the location and industry of the target assets, the investment amount, and the identity and ownership structure of the Chinese investor. An outbound investment made by Chinese individual investors through onshore or controlled offshore vehicles will be subject to relevant NDRC and MOFCOM filing or reporting mechanisms.

NDRC regulates Chinese companies' outbound investment activities on a project-by-project basis through a multilayered approval and filing regime. Under the Administrative Measures for Enterprise Outbound Investment (Regulation No. 11), which entered into force on 1 March 2018, a Chinese investor is required to make a filing with NDRC or its local counterpart (depending on whether the Chinese investor is a centrally managed SOE and whether the investment size (including equity and debt investments made by not only the Chinese investor but also the offshore entities controlled by the Chinese investor) reaches US$300 million) and obtain an NDRC filing notice for an outbound investment transaction that does not involve a 'sensitive country or region' (countries and regions that are subject to investment restrictions under international treaties, war or civil commotion, or that have no diplomatic relations with China) or a 'sensitive industry' (which was further clarified by NDRC in 2018 (see below for more details)), and, in cases where the transaction involves a sensitive country or region or a sensitive industry, the Chinese investor is required to apply for and obtain an outbound investment approval from the central NDRC. In addition, there has been a requirement that if the size of a Chinese outbound investment reaches or exceeds US$300 million, the Chinese investor is required to submit a project information report to NDRC and obtain an NDRC project confirmation letter before signing a definitive purchase agreement, submitting a binding offer or bid, or submitting applications with foreign governmental authorities; however, this requirement of an NDRC project confirmation letter was abolished from 1 March 2018 following the entry into effect of the new NDRC outbound rules. In addition to Regulation No. 11, NDRC promulgated a Catalogue of Sensitive Industries for Outbound Investment 2018 (the Sensitive Industries Catalogue) in January 2018, with effect from 1 March 2018. In June 2018, NDRC released the Answers to Frequently Asked Questions Concerning Outbound Investment by Enterprises (the Answers to FAQs) on its official website, providing clarification for 61 frequently asked questions regarding the application of Regulation No. 11. NDRC made rather restrictive interpretations on the scope of sensitive projects. These industries or projects include real estate, hotels, offshore equity investment funds or investment platforms without specific underlying industrial projects, sports clubs, cinemas and the entertainment industry. The designation of real estate, hotels and offshore equity investment funds or investment platforms without specific underlying industrial projects as sensitive industries has drawn substantial attention, as there were significant amounts of investment in these industries both in numbers and deal values in the few years before 2018. Regulation No. 11 adopts a control-based approach that includes in the verification scope all sensitive projects made by offshore entities under the control of Chinese investors, regardless of whether or not the Chinese investors provide financing or guarantees for these projects. It is also notable that the restrictive interpretations of sensitive projects apply only to these three industries, namely real estate, hotels and offshore equity investment funds or investment platforms without specific underlying industrial projects, and do not include cinemas, entertainment, sports clubs or other sensitive industries. In addition to the aforementioned restrictive interpretations, the Answers to FAQs also include detailed explanations and instructions for each of the sensitive industries to clarify the scope of application of sensitive projects.

In addition to the multilayered approval and filing regime implemented by NDRC, outbound investment transactions are also subject to the reporting and filing requirements implemented by MOFCOM. Under the Interim Measures for the Recordation (or Confirmation) and Reporting of Outbound Investment (Circular No. 24), which was promulgated by MOFCOM on 8 January 2018, each Chinese investor that conducts an outbound investment transaction shall file the details of the outbound transaction made by it with MOFCOM or its local counterpart. Circular No. 24 applies the same criteria under Regulation No. 11 for the initial filing or reporting of an outbound investment transaction. In addition, Circular No. 24 further requests the Chinese investor to update its registration with respect to the approved outbound investment transaction with competent MOFCOM on a periodic basis. On 1 July 2019, MOFCOM promulgated the Implementation Regulation of Interim Measures for the Recordation (or Confirmation) and Reporting of Outbound Investment (Circular No. 24 Implementation Rules), which provides the filing requirements in detail. Under Circular No. 24 Implementation Rules, each Chinese investor shall file a semi-annual report with respect to the approved outbound investment every six months, which shall include, without limitation, the financial performance of the invested foreign business. If the Chinese investor encounters any problem with respect to the approved outbound investment (e.g., war, governmental default, major health emergency), it shall promptly report the event to competent MOFCOM.

NDRC approvals and filings and MOFCOM initial approvals and filings are typically the pre-closing procedures on the part of Chinese investors in outbound investment transactions, particularly if the Chinese investor needs to establish an offshore subsidiary or to use onshore financing (whether equity or debt financing), or both, to complete the transaction. If a Chinese buyer uses an existing offshore entity as the acquisition vehicle and has sufficient funds offshore to complete the transaction, NDRC approvals and filings and MOFCOM initial approvals and filings, and even registration with the State Administration of Foreign Exchange (SAFE) as described below, may not be required by the parties as closing conditions (although the Chinese buyer may nevertheless go through the process of obtaining and completing NDRC approvals and filings and MOFCOM initial approvals and filings to be able to repatriate funds from the relevant investment back to China in the future). However, the aforementioned practice is restricted by the new NDRC outbound rules, which require that an investment of US$300 million or more made by an offshore entity controlled by a Chinese investor be 'reported' to the central NDRC, which will be a new post-closing government filing for an outbound transaction consummated by a Chinese investor's offshore subsidiary by utilising offshore financing.

After obtaining NDRC approvals and filings and MOFCOM initial approvals and filings, a foreign exchange registration with SAFE through a local Chinese bank is required for the currency conversion and remittance of the purchase price out of China. However, this will not be applicable if a Chinese investor uses offshore capital to fund the transaction. In addition, a foreign exchange registration would be required in the case of an earnest deposit to be paid from China to overseas immediately upon or within a short period of the signing of a definitive purchase agreement. Upon registration, a Chinese investor may remit the registered amount of the deposit to offshore. However, if a Chinese investor uses its offshore funds to pay the deposit, this registration may not be applicable. The registration can be handled by a local Chinese bank concurrently with NDRC project confirmation process if the amount of the deposit does not exceed US$3 million or 15 per cent of the purchase price. Payment of deposits of higher amounts must be approved by SAFE on a case-by-case basis after completing NDRC project confirmation process.

A Chinese SOE as a buyer may also need approvals from the state-owned Assets Supervision and Administration Commission of the State Council or its local counterpart, or sometimes, alternatively, approvals from its group parent company. Depending on the transaction value and structure, a Chinese-listed company may need to obtain stockholders' approval before closing and make the necessary disclosures required by the Chinese securities exchange rules. The State Council requires the establishment of share capital systems for SOEs and improved auditing systems to monitor SOEs' outbound equity investments. This principle, accompanied by current rules applicable to SOEs' investments (e.g., appraisal), are regarded as intended to preserve and increase the value of state-owned overseas assets.

Since late 2016, it has been reported that the increasing flow of Chinese outbound investment activities has become a source of concern to Chinese authorities, which have adopted more stringent control and supervision on outbound investment activities and capital flow. In an official press release dated 6 December 2016, the central governmental authorities, including NDRC, MOFCOM and SAFE, in their response to a media inquiry on tightened scrutiny over outbound investment transactions, mentioned that they had been alerted to some irrational outbound investment activities in real estate, hotels, film studios, the entertainment industry and sports clubs, and potential risks associated with overseas investment projects involving:

a large investments in businesses that are not related to the core businesses of the Chinese investors;
b outbound investments made by limited partnerships;
c investments in offshore targets that have assets of a value greater than the Chinese acquirers;
d projects that have very short investment periods; and
e Chinese onshore funds participating in the going-private of offshore-listed China-based companies.

Further, on 4 August 2017, the State Council issued the Guidance Opinions on Further Promoting and Regulating Overseas Investment Direction (the Guidance Opinions), which highlighted certain industry-specific guidance affecting Chinese outbound investments, including:

a encouraging investments in overseas high-tech and manufacturing companies and in setting up overseas research and development (R&D) centres;
b promoting investments in agricultural sectors;
c regulating investments in oil, mining and energy sectors based on an evaluation of the economic benefits;
d restricting investments in real estate, hotels, cinemas, the entertainment industry and football clubs; and
e prohibiting investments in the gambling and pornography sectors.

In addition, the Guidance Opinions classify investments in offshore private equity funds or investment vehicles that do not have investment projects as restricted investments, which would be subject to pre-completion approvals by NDRC.

The tightened control on outbound investment activities and capital flow not only affects Chinese investors but is also relevant to international private equity participants from at least two perspectives: when a private equity participant intends to partner with a Chinese investor in M&A activities outside China or when a private equity participant is considering a Chinese buyer for a trade sale as its exit route. NDRC promulgated the Sensitive Industries Catalogue in 2018, formally adopting the aforementioned measures. In these scenarios, the private equity investor must take into account the potential risk that the Chinese party may not be able to come up with sufficient funds offshore in time to complete the transaction offshore or ultimately complete the transaction. Further, when private equity investors consider a Chinese buyer as a potential exit route, in addition to the completion risk, a private equity seller would be well-advised to also consider the risk profile of the transaction and the target business in the context of Chinese regulations (including the relevant industry, the financing structure and the identity of the Chinese buyer) to evaluate the related risks and impacts, including reputational risks and social impacts, if the Chinese buyer was required to divest the business shortly after completing the transaction or was unable to provide the required funding offshore for the business, which might put stress on various aspects of the operation of the business and might also force a premature sale.

Non-Chinese investment approvals

The United States, the European Union (EU) and other countries scrutinise or regulate international business activities, including relevant Chinese outbound investment activities, to achieve objectives related to, inter alia, national security, foreign investment control and anti-monopoly. In connection with Chinese investments in the United States or EU countries, the relevant parties should be aware of potential non-Chinese approvals that may be mandatory or necessary in the jurisdiction where the target is located depending on the nature and size of the transaction, which may include US and EU merger control review, and a Committee on Foreign Investment in the United States (CFIUS) review. A CFIUS review is often perceived among parties to Chinese outbound investments in the United States as one of the major foreign regulatory hurdles. The scrutiny of acquisitions by Chinese companies has been further intensified in the United States (following the reform of CFIUS legislation in late 2018) and in some other western countries.

CFIUS is an inter-agency committee of the US government that is empowered to monitor foreign direct investment in the United States by a non-US person, to evaluate whether the transaction may create national security risks. CFIUS establishes the process for reviewing the national security impact of foreign investments, joint ventures and other investments into the United States, and analyses a broad range of national security factors to evaluate whether a transaction may create a national security risk to the United States.

On 13 August 2018, US President Trump signed into law the Foreign Investment Risk Review Modernization Act (FIRRMA), which substantially reformed and expanded the jurisdiction and powers of CFIUS, including (1) expanding the jurisdiction of CFIUS, which expressly included not only controlling direct investments, but also certain non-controlling investments for the first time; (2) adopting a mandatory declaration process for certain covered transactions together with mandatory waiting periods for the closing of those transactions; (3) extending the statute timeline in respect of the review process; and (4) granting enforcement authority for CFIUS to suspend transactions. On 11 October 2018, CFIUS further promulgated a pilot programme, which took effect on 11 November 2018, strengthening and detailing regulations affecting 27 identified industry sectors (e.g., R&D in biotechnology, petrochemical manufacturing and semiconductor and related device manufacturing). To further enhance the pilot programme promulgated in October 2018, on 17 September 2019, the US Department of the Treasury promulgated the Draft Implementation Regulation of FIRRMA (the Draft FIRRMA Implementation Regulation). The Draft FIRRMA Implementation Regulation introduces the concept of a 'technology, infrastructure and data (TID) US business' for the first time to further emphasise the gravity and sensitivity of foreign investment in business sectors relating to intellectual property, critical infrastructure and personal data. According to the Draft FIRRMA Implementation Regulation, CFIUS further expanded its jurisdiction to all 'covered investments', which includes any investment made by a non-US investor in a TID US business. On 13 January 2020, the US Department of the Treasury published the finalised Draft FIRRMA Implementation Regulation, which became effective on 13 February 2020. Given that the relationship between the United States and China has deteriorated since the Trump administration took office and has dropped to a record low point as a result of the US–China trade war that began in 2019, FIRRMA, the pilot programmes implemented by CFIUS and the Draft FIRRMA Implementation Regulation are likely to have a dramatic and disproportionate impact on Chinese outbound investments into the United States, especially investments in highly sensitive areas (particularly, any TID US business) in the near future.

Recent major Chinese outbound investment transactions abandoned or terminated on account of CFIUS issues are listed as follows:

a the abandonment in May 2018 of the US$200 million acquisition of a controlling stake in US hedge fund Skybridge Capital by HNA Group;

b the abandonment in February 2018 of the US$100 million acquisition of 63 per cent shares in Cogint Inc (listed on NASDAQ) by Bluefocus because of the parties' failure to obtain CFIUS approval;

c the termination in February 2018 of the US$580 million acquisition of US semiconductor testing company Xcerra Corp by Hubei Xinyan Equity Investment Partnership because of the parties' failure to obtain CFIUS approval;

d the termination in January 2018 of an attempted US$1.2 billion strategic acquisition of US money transfer company MoneyGram International Inc by Chinese financial service provider and affiliate of Alibaba, Ant Financial Services Group, because of CFIUS refusal of approval over national security concerns;

e the termination in November 2017 of a US$100 million investment in US financial services firm Cowen Inc by CEFC China Energy Company Limited;

f the executive order issued by President Trump in September 2017 blocking a proposed US$1.3 billion sale of Lattice Semiconductor Corporation, a publicly traded US manufacturer of programmable logic chips, to a Chinese state-backed private equity firm;

g the abandonment in September 2017 of the US$285 million proposed 10 per cent equity investment in HERE Technologies by a part-Chinese consortium;

h the termination in July 2017 of the US$103 million acquisition of US in-flight entertainment company Global Eagle by the Chinese conglomerate HNA because of the parties' inability to obtain CFIUS approval;

i the executive order issued by President Obama in December 2016 blocking the proposed acquisition of German semiconductor manufacturer Aixtron SE's US business by a group of Chinese investors led by Fujian Grand Chip Investment Fund LP;

j the termination in January 2016 of the attempted acquisition of Philips NV's Lumileds LED business by a consortium of Chinese investors led by GO Scale Capital because of the parties' failure to address national security concerns raised by CFIUS;

k the termination in February 2016 of the proposed investment in Western Digital by Unis Union and Unisplendour after CFIUS determined to investigate the transaction; and

l the rejection by US chipmaker Fairchild Semiconductor International in February 2016 of a bid from China Resources Microelectronics citing an 'unacceptable level' of CFIUS risk.

Due to the aggressive CFIUS policies, large cross-border investment attempts by Chinese investors in the US market have almost dried up since 2019. As a result, there is no relevant data to report for 2019 and 2020. In addition to the United States, other western countries have tightened control over investment by Chinese companies in certain sensitive industries, which has resulted in the termination of certain acquisition attempts by Chinese companies. Germany enacted an amendment to the German Foreign Trade and Payments Ordinance (AWV) in July 2017, pursuant to which any acquisition of at least 25 per cent voting rights of German companies by a non-European Economic Area investor is subject to a foreign investment control approval by the German government. On 20 December 2018, Germany promulgated a new amendment to the AWV, lowering this threshold to 10 per cent for certain investments in 'critical infrastructure' or 'military-related products' industries. Notable examples of failed attempts by Chinese companies in Germany include an attempted takeover of the Westphalian mechanical engineering company Leifeld Metal Spinning on 1 August 2018 by Yantai Taihai, a leading participant in the Chinese nuclear sector.

III YEAR IN REVIEW

i Recent deal activity

Going-private transactions

The trend of US-listed Chinese companies going private heated up to record levels in 2015 and 2016, retreated from these peak levels in 2017, cooled down further in 2018 and 2019, and revived in 2020. Based on statistics obtained through searches on Thomson ONE:

- *a* during 2014, four US-listed going-private transactions were announced (with four withdrawn) and three were closed;
- *b* during 2015, eight US-listed going-private transactions were announced (with seven withdrawn) and 18 were closed;
- *c* during 2016, eight US-listed going-private transactions were announced (with five withdrawn) and six were closed;
- *d* during 2017, three US-listed going-private transactions were announced and one was closed;
- *e* during 2018, five US-listed going-private transactions were announced (with one withdrawn);
- *f* during 2019, four US-listed going-private transactions were announced and none was closed; and
- *g* during 2020, 13 US-listed going-private transactions were announced and six were closed.

The struggle by some Chinese companies against market research firms and short sellers such as Muddy Waters Research, Citron Research and Blue Orca Capital has often provided interesting perspectives on the environment faced by Chinese companies listed in the United States. These market research firms and short sellers have gained name recognition by issuing critical research reports targeting Chinese companies listed in the United States. The business model of such firms appears to involve issuing negative research reports on a public company while simultaneously taking a short position in the company's stock, which often enables these firms to make substantial profits even if their research and accusations are not ultimately proven correct. Notably, these firms have not limited their coverage to companies listed through reverse takeovers (RTOs),[5] which are commonly considered to have lower profiles and to be more prone to disclosure issues than companies listed through a traditional IPO process.

5 In a typical RTO, a private company merges with a publicly traded company (often a shell having limited assets and operations at the time of the RTO), whereby the private company injects its assets into the public company and the shareholders of the private company become controlling shareholders of the public company. As a result of the merger, the (formerly) private company's business essentially becomes listed without that company having paid the cost or gone through the vigorous vetting process or fulfilled the burdensome disclosure requirements of an IPO.

Following the consequential coverage by Muddy Waters of Orient Paper Inc in 2010 and Sino-Forest Corp in 2011, the most notable case in 2012 arose when, on 18 July 2012, Muddy Waters published a scathing report on New Oriental Education & Technology Group Inc on its website, sinking the company's share price to US$9.50 by 35 per cent in one day. New Oriental is widely considered one of the more reputable and well-run Chinese companies listed in the United States, and it went public in a traditional IPO. The company's stock price subsequently recovered to US$13.90 one and a half months after the Muddy Waters report came out, suggesting the market's belief that the accusations were not justified. New Oriental's stock, at the time of writing, trades at US$188.00. On 14 November 2018, Blue Orca Capital issued a short-selling report, accusing Pinduoduo Inc, a social commerce company in China, of inflating revenues and falsely trimming losses. Blue Orca Capital predicted a 59 per cent drop in the company's stock price in its negative report, whereas Pinduoduo's stock price experienced a surge after the announcement of its quarterly result following Blue Orca Capital's report, suggesting that investors in the US market as a whole can act quite independently of such negative research reports and short-selling attempts. On the other hand, on 24 October 2013, Muddy Waters published an 81-page report labelling Beijing-based mobile provider NQ Mobile Inc a 'massive fraud', sending the company's share price tumbling more than 60 per cent in three days. NQ Mobile's share price experienced substantial recovery during the fourth quarter of 2013 and the first quarter of 2014 but lost more than 80 per cent in value amid continued attacks from Muddy Waters and traded below US$4 (or less than one-fifth of its 2013 high) for most of 2017. NQ Mobile Inc was eventually delisted from the New York Stock Exchange (NYSE) on 9 January 2019.

Regardless of the ultimate outcome, the fact that a single research report could inflict sudden and substantial damage of this nature on a company's reputation and stock price strongly suggests a widespread underlying lack of confidence in listed Chinese companies. The success of these research and short-selling firms could also be partially attributed to a lack of access to and understanding of the Chinese business environment and markets, which have afforded a few firms that have conducted on-the-ground research outsize influence in the market. Further, their critical coverage, which often involves allegations of disclosure issues or even fraud, has attracted regulatory attention and shareholder lawsuits and may have encouraged less-than-generous media coverage of Chinese companies in general. For instance, in 2013, the SEC publicised its investigations and charges against US-listed China MediaExpress and its chair and CEO for fraudulently misrepresenting the company's financial condition to investors in SEC filings dating back to November 2009, and against RINO International Corporation, a China-based manufacturer and servicer of equipment for China's steel industry, and its chair and CEO for a series of disclosure violations based on accounting improprieties, after (or shortly before) Muddy Waters initiated coverage and issued negative reports regarding these companies. The above factors, in turn, are believed to have contributed to suppressed valuations of US-listed Chinese companies in general.

Amid continued pressure from regulators, unfavourable media coverage, short-selling activities and shareholder lawsuits, the stock prices of many US-listed Chinese companies are perceived to be consistently depressed. Further, even Chinese companies relatively free of negative coverage have often felt that their business model and potential are not fully appreciated by the US market, and that they would be more favourably received by a market closer to China – for example, the Hong Kong Stock Exchange or the Chinese A-share market – where market research and media coverage are seen as being more positive and reflecting a proper appreciation of the business culture and environment in China, resulting in a better understanding of the specific business models and potential of the companies covered. At the same time, the booming domestic Chinese stock market (with an average price-to-earnings (P/E) ratio of 16.39 at the end 2020, 14.55 at the end 2019, 12.49 at the end of 2018, 18.08 at the end of 2017, 15.91 at the end of 2016 and 17.61 at the end of 2015 for A-share listed companies listed on the Shenzhen Stock Exchange, and an average P/E ratio of 34.51 at the end of 2020, 26.15 at the end of 2019, 20 at the end of 2018, 36.21 at the end of 2017, 41.62 at the end of 2016 and 53.34 at the end of 2015 for A-share listed companies listed on the Shenzhen Stock Exchange) often offered valuations several times over those offered in the United States.

The disparity in valuation levels and perceived receptiveness naturally presented a commercial case for management and other investors to privatise US-listed Chinese companies, with the hope of relisting them in other markets. One of the most significant going-private transactions to date was the proposed acquisition of Qihoo 360 Technology Co Ltd by a consortium consisting of its co-founder and chair, Mr Hongyi Zhou, its co-founder and president, Mr Xiangdong Qi, and certain other investors, in a transaction valuing the NYSE-listed company at approximately US$9.3 billion (not taking into account rollover shares to be cancelled for no consideration). This deal was closed in July 2016 and was the largest privatisation of a US-listed Chinese company (the second-largest being the take-private of Qunar Cayman Islands Ltd by Ocean Imagination LP, which was signed in 2016, valuing Qunar at US$4.59 billion).

While earlier going-private transactions involving US-listed Chinese companies tended to run more smoothly, some more recent transactions of this type went through more eventful processes, suggesting the challenges in completing such transactions have been increased by a more competitive dealmaking environment with a shrinking pool of desirable targets and a more seasoned shareholder base. For example, in the going-private transaction of NASDAQ-listed Yongye International Limited, the initial bid of the buyer consortium led by Morgan Stanley Private Equity Asia and the company's CEO failed to receive the requisite shareholders' approval, and the transaction was approved in a subsequent shareholder meeting only after the buyer consortium raised its bid by 6 per cent. In the going-private transaction of hospital operator Chindex International Inc, the initial offer of US$19.50 per share from the buyer consortium comprising Shanghai Fosun Pharmaceutical, TPG and the company's CEO was countered by a rival offer of US$23 per share received by the company in the 'go-shop' period, and the buyer consortium eventually had to raise its offer to US$24 a share to secure the transaction, raising the total price tag to US$461 million. A more recent case that has been drawing market attention is iKang Healthcare. While the iKang special committee was considering a going-private proposal submitted in August 2015 by a consortium led by Ligang Zhang, its founder, chair and CEO, and FountainVest, in November 2015 the iKang board received a competing proposal from a consortium led by one of iKang's main competitors, Meinian Onehealth Healthcare (Group) Co, Ltd, a Shenzhen-listed company. The founder-led consortium and the Meinian-led consortium then engaged in an intense publicity war, iKang's board adopted a poison pill and Meinian increased its offer price for the second time. In June 2016, after the board of directors of iKang received a competing go-private proposal from Yunfeng Capital (a private equity firm co-founded by Alibaba Group Holdings Ltd's Jack Ma and Focus Media Holdings' David Yu) to acquire the entire share capital in iKang, both the founder-led consortium and the Meinian-led consortium withdrew their going-private proposals. After 21 months' negotiation, a reorganised consortium led by Yunfeng Capital, Alibaba Group Holdings and BOYU Capital, Ligang Zhang and Boquan He, the vice president of iKang, managed to enter into a merger agreement on 26 March 2018, pursuant to which the reorganised consortium proposed an offer at US$41.20 per share (or US$20.60 per American depositary share of the company (ADS)), with a total value of approximately US$1.097 billion. This offer was approved by iKang's general shareholders' meeting on 20 August 2018, and the merger was closed and officially announced on 18 January 2019. In addition, recently, another going-private deal of China Biologic Products Holdings, Inc (Biologic), a leading blood plasma-based biopharmaceutical company, caused public attention. In September 2019, Biologic announced that it had received a take-private proposal for US$4.59 billion in cash from a consortium of buyers (including Beachhead Holdings Limited, CITIC Capital China Partners IV, LP, PW Medtech Group Limited, Parfield International Ltd, HH Sum-XXII Holdings Limited and V-Sciences Investments Pte Ltd). On 19 November 2020, Biologic announced that it has entered into a merger agreement, pursuant to which the buyer consortium proposed an offer at US$120.00 per share, with a total value of approximately US$4.76 billion. The merger is currently expected to close during the first half of 2021. The merger will result in Biologic becoming a privately held company and its shares will no longer be listed on the NASDAQ Global Selected Market.

The going-private trend was not limited to entities resulting from an RTO. While companies listed through RTOs may be easier targets of short sellers, companies that listed in the United States through a conventional offering may be more appealing targets for private equity investors given that these companies are often perceived to be of higher quality and less likely to have accounting or securities law compliance issues, and thus are more likely to grab a higher valuation later on, whether in an IPO in a market closer to China or a trade sale. Indeed, all of the examples discussed above involved companies listed through a traditional IPO.

A majority of US-listed China-based companies involved in going-private transactions in recent years are incorporated in the Cayman Islands. Five out of seven US-listed China-based companies that announced receipt of a going-private proposal in 2020 were Cayman Island companies that accessed the public markets through a conventional IPO, compared with two Cayman Islands company out of four US-listed China-based companies in deals announced in 2019, one Cayman Islands company out of five US-listed China-based companies in deals announced in 2018, one Cayman Islands company out of three US-listed China-based companies in deals announced in 2017, six Cayman Islands companies out of eight US-listed China-based companies in deals announced in 2016, seven Cayman Islands or British Virgin Islands companies out of eight US-listed China-based companies in deals announced in 2015, and four Cayman Islands or British Virgin Islands companies out of four China-based companies in deals announced in 2014. This was driven in part by the introduction of new merger legislation in the Cayman Islands in April 2011, which made statutory merger under the Cayman Islands Companies Law an attractive route to effect a going-private transaction. The merger process typically requires the buyer group to form a new Cayman Islands company that will merge with, and be subsumed by, the listed Cayman target. Under the 2011 amendments to the Cayman Islands Companies Law, the shareholder approval threshold for a statutory merger was reduced from 75 per cent to a two-thirds majority of the votes cast on the resolution by the shareholders present and entitled to vote at a quorate meeting, in the absence of any higher threshold in the articles of association of the target company. In addition, a merger under the Cayman Islands Companies Law is not subject to the 'headcount' test required in a scheme of arrangement, the primary route for business combination under the Cayman Islands Companies Law before merger legislation was introduced in the Cayman Islands. The headcount test requires the affirmative vote of 'a majority in number' of members voting on the scheme, regardless of the amount or voting power of the shares held by the majority, which means that a group of shareholders holding a small fraction of the target's shares could block a transaction. The lower approval threshold makes mergers an attractive option when compared with either a 'squeeze-out' following a takeover offer, which would require the buyer to obtain support from 90 per cent of the shares, or a scheme of arrangement, which would involve substantial closing uncertainty on account of the headcount test, as well as added time and costs arising from the court-driven process.

Most of the going-private transactions that closed in 2018 and 2017 took between two and five months from the signing of definitive agreements to closing (the rest took five months or longer) and were structured as a one-step, negotiated merger (as opposed to a two-step transaction consisting of a first-step tender offer followed by a second-step squeeze-out merger, which is another common approach to acquire a US public company). In a one-step merger, a company incorporated in a US state will be subject to the US proxy rules, which require the company to file a proxy statement with the SEC and, once the proxy statement is cleared by the SEC, to mail the definitive proxy statement to the shareholders and set a date for its shareholders' meeting. Transactions involving affiliates (e.g., management) are further subject to Rule 13e-3 of the Securities and Exchange Act and are commonly referred to as '13e-3 transactions'. A 13e-3 transaction requires the parties to the transaction to make additional disclosures to the public shareholders, including as to the buyer's position on the fairness of the transaction. An important related impact is that, whereas the SEC reviews only a fraction of all proxy statements, it routinely reviews disclosure in 13e-3 transactions, which can lengthen the transaction process by several months. Further, companies incorporated outside the United States and listed on US stock exchanges (including recent going-private targets that often are incorporated in the Cayman Islands or the British Virgin Islands) are known as foreign private issuers (FPIs). While FPIs are not subject to the proxy rules, they are subject to 13e-3 disclosure obligations, and if they are engaged in a 13e-3 transaction, they would be required to include as an exhibit to their 13e-3 filings information that is typically very similar to a proxy statement prepared by a US domestic issuer. Accordingly, both a transaction involving a US domestic company and a 13e-3 transaction involving an FPI follow a comparable timetable for purposes of SEC review.

The recent tightening of control on capital flows out of China, including regulations restricting Chinese onshore funds from participating in the going-private of offshore-listed China-based companies may also create hurdles for going-private transactions of offshore-listed China based companies as these transactions typically involve buyer parties or financing, or both, from China. It remains to be seen how long the tightened control on outbound capital flow will last and its exact impact on going-private transactions involving Chinese companies.

Another key recent trend in going-private transactions of US-listed Chinese companies that are incorporated in Cayman is the rise of dissenting shareholders in such deals. Many of the US-listed and Cayman-incorporated Chinese companies that have recently gone private are facing dissenting shareholder litigations under Section 238 of the Companies Law of the Cayman Islands by investors who claim that their shares are worth more than the offer price. Often, the buyer groups are accused of forcing through low-ball offers by virtue of their significant voting rights. Low-ball offers are possible partially because Cayman Islands law allows buyer groups to vote their shares, including super voting shares, together with the other shareholders, towards the two-thirds in voting power represented by shares present and voting at the shareholders' meeting required for approval of the merger. For example, the buyer groups in the take-private of Mindray and Shanda Games held 63.1 and 90.7 per cent, respectively, in voting rights in the relevant target companies. Some private equity shareholders in going-private transactions have publicly complained or made Schedule 13D filings with the SEC about low-ball offers from Chinese buyout groups.

In January 2017, the Cayman Islands Grand Court delivered its interlocutory judgment regarding the *Blackwell Partners LLC v. Qihoo* case, in which it decided that interim payments could be requested by dissenting shareholders and granted by the court during the judicial proceedings for the merger transactions initiated under Section 238 of the Companies Law of the Cayman Islands. In April 2017, the Cayman Islands Grand Court delivered its ruling in the *Shanda Games* case, in which it found that the fair value of the shares owned by the dissenting shareholders (which were all funds managed by Hong Kong-based fund manager Maso Capital) was more than double the consideration offered in the take-private scheme. These decisions, in hindsight, are perceived to be instrumental in shaping the dissenting shareholder landscape in the Cayman Islands. The *Shanda Games* case was the second Cayman court decision on fair value in a merger, and the first one that required the Cayman court to determine the value of a company with assets and business operations in China. While the *Shanda Games* decision further propped up expectations of dissenting shareholders of a court-determined fair value that is substantially higher than the price offered by the buyer group, the *Qihoo* decision (together with a few other similar decisions) perhaps dealt the more decisive blow by enabling the dissenting shareholders to recover interim payments (which are often equal to the price offering in the take-private) relatively soon after initiation of litigation, significantly reducing the cost of funds for dissenting shareholders.

Currently, several similar additional cases are pending in the Cayman Islands courts, and it remains to be seen whether future Cayman court decisions will balance market expectations and discourage speculative dissenters. One of the cases demonstrating these balancing efforts is the decision of the Cayman Islands Grand Court in the going-private transaction of eHi Car Services Ltd (eHi), the provider of passenger car rental services in China. In June 2018, the Cayman Islands Grand Court decided that the dissenting minority shareholder of eHi could not pursue a winding-up petition intended to delay, or to gain leverage for, a competing merger bid for the privatisation of eHi. To compete against a proposal at US$13.35 per ADS offered by a consortium led by Baring Private Equity Asia Limited and Ruiping Zhang, the chairman of eHi group, Ctrip Investment Holding Ltd, a dissenting minority shareholder of eHi, submitted a counter proposal at US$14.50 per ADS. This proposal, although at a higher offer price, was not recommended by the special committee to the board of directors of eHi because it was considered to be a last-minute increase from the price offered in the proposal submitted by Baring and the chairman. Ctrip Investment Holding Ltd then presented a winding-up petition together with an immediate injunction to the Cayman Islands Grand Court. The court struck out the winding-up petition in its entirety on the ground of abusive use of the winding-up jurisdiction by the dissenting shareholder. Although a reorganised consortium led by Ctrip Investment Holding Ltd and Ocean Imagination LP eventually won the competing bid with a revised proposal at US$15.50 per ADS in May 2018, the Cayman Islands Grand Court's decision in this case now stands as an exemplary case for the principle that a winding-up petition may not be abusively used by dissenting shareholders to avoid a going-private transaction.

Other notable transactions

Consolidations in the vying internet and technology industries in China have been soaring and hitting headlines for several consecutive years. In February 2015, Didi Dache and Kuaidi Dache, two of China's leading ride-hailing apps, announced their US$6 billion stock-for-stock merger, which was closed weeks thereafter, creating Didi Kuaidi (later rebranded as Didi Chuxing), one of the world's largest smartphone-based transport service providers. In August 2016, Didi Chuxing announced its acquisition of Uber China (Uber's China business), which was valued at around US$8 billion, and after the transaction, Didi Chuxing was estimated to be worth around US$35 billion. Uber obtained a 17.7 per cent stake in Didi Chuxing and became the largest shareholder of Didi Chuxing, with other existing investors in Uber China, including Chinese search giant Baidu Inc, taking another 2.3 per cent stake in Didi Chuxing. In April 2015, NYSE-listed 58.com purchased a 43.2 per cent fully diluted equity stake in Ganji.com for US$1.56 billion, initiating the long-term strategic combination of these two major online classified providers in China. In October 2015, two major online-to-offline (O2O) service providers in China, the group-buying service Meituan.com and restaurant review platform Dianping Holdings, announced a merger to create a US$15 billion giant player in China's O2O market covering restaurant review, film booking and group buying businesses. In late October 2015, China's largest online tourism platform, Ctrip, announced the completion of a share exchange with Baidu, Inc through which it gained control of its rival Qunar. The transaction formed a dominant player in the online trip booking market in China valued at US$15.6 billion. In January 2016, Meilishuo.com, a Chinese fashion retailer backed by Tencent Holdings Ltd announced its merger with its chief rival, Mogujie.com, to form the biggest fashion-focused e-commerce service provider in China with a valuation of nearly US$3 billion. In September 2017, the merger of two major online film-ticketing platforms was announced between Maoyan (majority-owned by Chinese television and film company Enlight Media) and Weying (backed by Tencent). Following the merger, the combined Maoyan-Weying entity will control 43 per cent of China's online ticketing market, according to Enlight Media's announcement. In April 2018, Ele.me, a leading online food order and local delivery services platform in China, announced the completion of its merger into Alibaba Group Holdings Limited (Alibaba), with a valuation of US$9.5 billion. Following the merger, Ele.me has become a part of the Alibaba ecosystem by complementing Alibaba's current local services platform, Koubei, and providing extended synergies to Alibaba's new retail business sector in the long run. In September 2019, Kaola.com, a leading cross-border e-commerce platform in China, announced the completion of its merger into Alibaba, with a valuation of US$2 billion. Kaola.com was one of the biggest competitors of Tmall.com (the core cross-border e-commerce platform of Alibaba) in the field of cross-border e-commerce business in China. Upon the merger, Kaola.com retains its trade name and independent operations, while the management team of Tmall.com took charge of the corporate governance of Kaola.com. On 14 April 2020, Jumei International Holding Ltd (Jumei), a leading fashion and lifestyle solutions provider in China, announced the completion of its merger with Jumei Investment Holding Ltd, a unit of Super ROI Global Holding Ltd, with a valuation of US$126.51 million. Following the merger, Jumei will have greater flexibility to focus on long-term business goals, including pursuing strategic truncations and acquisitions, without the constraint of the public markets emphasis on quarterly earnings. On 28 September 2020, SINA Corporation (SINA), a leading online media company serving China and the global Chinese communities, announced that it has entered into a merger agreement, pursuant to which New Wave MMXV Ltd agreed to acquire the remaining 87.878 per cent interest in SINA for a total US$2.59 billion in a leveraged buyout transaction, via an unsolicited management buyout offer. The merger is currently expected to close during the first quarter of 2021. On 17 August 2020, Yintech Investment Holdings Limited (Yintech), a leading provider of investment and trading services for individual investors in China, announced that it has entered into a merger agreement, implying an equity value of Yintech of approximately US$540.2 million. On 19 November 2020, Yintech announced the completion of its merger with Yinke Merger Co Ltd.

In addition to the iconic mergers described above, the headline private equity investments in 2018 primarily focused on China's technology industries. In April 2018, Pinduoduo Inc, the leading 'new-ecommerce' platform, which features a team purchase model, announced the completion of its pre-IPO financing at a valuation of US$15 billion with Sequoia Capital and Tencent Holdings. In June 2018, Ant Financial Services Group, the leading online payment service provider and the financial arm of the Alibaba Group, announced the completion of its US$14 billion Series C financing (with a valuation of US$150 billion) from a series of private equity and sovereign funds, including Baillie Gifford & Co, BlackRock Private Equity Partners, Canada Pension Plan Investment Board, The Carlyle Group, General Atlantic LLC, GIC Special Investments, Janchor Partners, Khazanah Nasional Bhd, Sequoia Capital, Silver Lake Partners, T Rowe Price, Temasek Holdings and Warburg Pincus. In October 2018, ByteDance/Toutiao, the leading internet content platform in China, announced the completion of its pre-IPO financing at a valuation of US$75 billion from leading global private equity funds, including General Atlantic, KKR, Primavera and SoftBank. In 2019, the highlights of private equity investments still targeted China's information technology industries. In February 2019, Chehaoduo Group (Guazi.com/Maodou.com), the leading e-commerce platform for used vehicles in China, announced the completion of its pre-IPO financing at a valuation of US$1.5 billion with SoftBank Investment Advisers. In November 2019, Cainiao Network Technology, one of the leading internet-based logistic service providers in China, announced the completion of its US$3.3 billion Series B financing pursuant to which Alibaba became the largest and controlling shareholder of the company. In December 2019, Kuaishou.com, the leading short video content provider and social platform in China, announced the completion of its pre-IPO financing at a valuation of US$3 billion from a series of private equity investors, including Boyu Capital, Sequoia Capital, Yunfeng Capital, Tencent and Temasek Holdings. On 18 September 2020, 58.com Inc., China's largest online classifieds marketplace, announced the completion of its merger (representing a deal size of US$8.39 billion) with Quantum Bloom Group Ltd. where 58.com; General Atlantic; Ocean Link; Warburg Pincus will collectively hold 85 per cent of the company upon the completion.

Another noteworthy trend in recent years has been private equity investors' participation in the mixed ownership reform of China's SOEs, where Chinese SOEs introduce private investors as minority shareholders. The highlight of this trend was the US$2.4 billion acquisition in 2014 of a 21 per cent equity interest in China Huarong Asset Management Co, Ltd, one of the largest asset management companies in China that was listed on the Hong Kong Stock Exchange in 2015 by a consortium of investors including China Life Insurance (Group) Company, Warburg Pincus, CITIC Securities International Company Limited, Khazanah Nasional Berhad, China International Capital Corporation Limited, China National Cereals, Oils and Foodstuffs Corporation, Fosun International Ltd and Goldman Sachs. Warburg Pincus was reported to have bought the largest portion of a 21 per cent stake for close to US$700 million. In August 2017, Wealth Capital, a Beijing-based private equity firm, set up a 5 billion yuan investment fund in Beijing targeting SOEs undergoing mixed ownership reform, in which the state-backed China Structural Reform Fund (a 350 billion yuan SOE restructuring fund backed by investors including China Chengtong Holdings Group, China Merchants Group and China Mobile) has invested and Wealth Capital acts as the fund manager, which is just one of many similar SOE reform-targeted funds that are being set up by state-owned capital and private equity funds across China.

ii Financing

Third-party debt financing continues to be available for acquisitions of Chinese companies by private equity investors. One key challenge, however, is that a Chinese target does not generally have the ability to give credit support (by way of guarantee or security over its assets) to a lender of offshore acquisition debt financing. Further, with a view to deleveraging and strengthening the economy, the Chinese authorities imposed various new foreign debt controls in 2018, which will impact the availability of security and financing to be provided by Chinese entities and financial institutions. For instance, insurance companies have been restricted from providing outbound guarantees for offshore debt; domestic Chinese companies raising foreign debt have been subject to higher governance standards; local government entities have been prohibited from providing outbound guarantees for offshore borrowing and real estate companies have been restricted from using foreign debt in relation to real estate projects. The covid-19 pandemic made the fundraising even worse. In the first quarter of 2020, the amount and number of funds raised showed a year-on-year percentage (YoY) decrease; Large-scale fundraising was impeded, the raising period was lengthened, and previous funds were postponed to the current period to complete raising. The fundraising amount decreased by 19.8 per cent YoY in the first quarter, and increased by 8.5 per cent in the second quarter, but it still showed a drop of 36.5 per cent YoY. The fundraising difficulty has not alleviated.

Many of the going-private transactions of US-listed Chinese companies involved debt financing, with the terms of the financings reflecting various commercial and structural challenges. The acquisition debt is typically borrowed by an offshore acquisition vehicle with the borrower giving security over its assets (including shares in its offshore subsidiaries, including the target) to secure repayment of the debt. As was the case in 2011 and 2012, the typical lender in these transactions spanned a wide range of financial institutions, from international investment banks to Chinese policy banks and offshore arms of other Chinese banks.

The Focus Media financing remains the standout transaction among debt-financed going-private transactions, due mainly to the size (US$1.52 billion) and complexity of the debt-financing facility, and the large consortium of both major international banks (Bank of America Merrill Lynch, Citibank, Credit Suisse, DBS Bank, Deutsche Bank and UBS) and offshore arms of Chinese banks (China Development Bank, China Minsheng and ICBC) that provided the financing. The 7 Days Inn financing was another notable debt-financed going-private transaction that was largely financed by a syndicate of Asian banks (Cathay United Bank, China Development Industrial Bank, CTBC Bank, Entie Commercial Bank, Nomura, Ta Chong, Taipei Fubon Commercial Bank, the Bank of East Asia and Yuanta Commercial Bank). The debt financing for the Giant Interactive take-private was also underwritten and arranged by a large syndicate of banks, including China Minsheng Banking Corp, BNP Paribas, Credit Suisse, Deutsche Bank, Goldman Sachs, ICBC International and

JP Morgan, in an aggregate amount of US$850 million. It can perhaps be considered a positive signal for any future going-private transactions that such a large number of financiers were comfortable to commit to funding this type of event-driven financing.

One notable development since 2015 is reflected in the going-private of Qihoo. Rather than obtaining the debt financing in US dollars offshore, the entire financing of a yuan equivalent of approximately US$3.4 billion was provided by one Chinese bank (China Merchants Bank (CMB)) onshore in yuan, with the buyer group having obtained the required Chinese regulatory approvals to convert the yuan funded by CMB into US dollars for payment of consideration to Qihoo's shareholders offshore. It remains to be seen whether this relatively novel deal structure will gain popularity, as both Chinese regulatory authorities and financial institutions gain more familiarity with this type of take-private transaction involving US-listed and China-based companies. The tightened control over outbound capital flow since late 2016 discussed above may deter the wide usage of this type of financing structure.

Another emerging trend in these offshore financing structures is that borrowers are seeking to access liquidity from the offshore debt markets in respect of what are essentially acquisitions of Chinese-based businesses – including as a means to take out bridge financing originating outside Asia.

iii Key terms of recent control transactions

Deal terms in going-private transactions

Most Chinese going-private transactions have involved all-cash consideration. Among the US-listed going-private transactions that closed during 2017, the per-share acquisition price represented an average premium of 17.5 per cent over the trading price on the day before announcement of receipt of the going-private proposal, according to statistics obtained through searches on Thomson ONE.

In a 13e-3 transaction (the going-private of a US-listed company involving company affiliates), the board of directors of the target typically appoints a special committee of independent directors to evaluate and negotiate the transaction and make a recommendation to the board. If the target is incorporated in the United States, the transaction almost inevitably will be subject to shareholders' lawsuits, including for claims of breaches of fiduciary duties, naming the target's directors as defendants. Because the target's independent directors often include US residents, a key driver of a transaction's terms is the concern for mitigating shareholders' litigation risk. Although no litigation claims for breach of fiduciary duties in a Chinese going-private transaction involving Cayman Islands or British Virgin Islands companies were reported to the public in 2017, it remains possible that, as the going-private trend persists, plaintiffs' firms will begin to articulate creative arguments in Cayman mergers and the Cayman courts may look to the body of Delaware law as persuasive precedent for adjudicating claims of breach of fiduciary duties. As a result, whether a going-private transaction involves a US or Cayman-incorporated target, targets typically insist that certain key merger agreement terms (in addition to the deal process) be within the realm of what constitutes the 'market' for similar transactions in the United States.

An important negotiated term in many going-private transactions is the required threshold for shareholder approval. Delaware law requires that a merger be approved by shareholders owning a majority of the shares outstanding. However, special committees often insist on a higher approval threshold, because under Delaware law the burden of proving that a going-private transaction is 'entirely fair' to the unaffiliated shareholders often shifts from the target directors to the complaining shareholders if the transaction is approved by a majority of the shareholders unaffiliated with the buyer group (i.e., a 'majority of the minority'). In US shareholder litigations, this burden shift is often seen as outcome-determinative. Under Cayman law, there is no well-defined benefit for the company to insist on a higher approval threshold than the statutory requirement of two-thirds of the voting power of the target present at the shareholders' meeting.

Another key negotiation point is whether the target would benefit from a go-shop period, which is a period following the signing of a transaction agreement during which the target can actively solicit competing bids from third parties. When defending against a claim of breach of fiduciary duty in Delaware, a company and its directors may point to a go-shop period in a merger agreement as a potentially helpful fact. Under Cayman law, however, there is not as much well-defined benefit for the company to insist on a go-shop period if the buyer consortium already has sufficient voting power to veto any other competing merger proposal.

Deal terms in growth equity investments

Deal terms are more difficult to evaluate and synthesise in private transactions, where terms are not publicly disclosed. Generally, in the context of a growth equity investment (which, as we have seen, remains the dominant type of deal both by number of deals and by aggregate amount invested), private equity investors often continue to expect aggressively pro-buyer terms. This expectation applies whether a transaction involves an onshore Sino-foreign joint venture or an investment offshore alongside a Chinese partner. In a subscription agreement for a growth equity deal, an investor typically benefits from extensive representations and warranties against which the company makes only limited disclosures; in some cases, an investor has knowledge that some representations may not be accurate, but still insists on a representation to facilitate a potential indemnification claim later. It is not uncommon for an investor to also enjoy an indemnity provision with a cap on the amount of losses subject to indemnification as high as the purchase price (or no cap at all), but with no deductible or threshold and with an unlimited survival period. Shareholders' agreements often contain similarly pro-investor terms, such as extensive veto rights (even in the case of a relatively small minority stake) and various types of affirmative covenants binding the company and its Chinese shareholders. If an investment is structured offshore (e.g., through a Cayman company that owns a Chinese subsidiary), a private equity investor may enjoy 'double-dip' economics pursuant to which, in the event of a liquidation or sale of the company, the investor is entitled to, first, a liquidation preference before any of the Chinese shareholders receive any proceeds and, second, the investor's pro rata share of the remaining proceeds based on the number of shares it owns on an as-converted basis. However, because there is no well-defined market when it comes to transaction terms in Chinese growth equity deals (unlike in going-private transactions), issuers also have opportunities to request, and sometimes obtain, terms that are very favourable to them. In growth equity deals in China, investors typically seek valuation adjustments or performance ratchet mechanisms, which can be structured as the adjustment to conversion prices of preferred shares that may be exchanged into a larger number of common shares at offshore level, or by compensation or redemption of equity interest in cash or transfer of equity interest to investors by the founders or original shareholders at onshore level without consideration or with nominal consideration, so as to achieve adjusted valuation of the target company following the failure to meet specified performance targets. In Chinese growth equity investments, the parties' leverage and degree of sophistication are more likely to dictate the terms that will apply to a transaction than any market practice or standard. In recent years, growth equity investments into high-growth technology companies have begun to contain less investor-friendly deal terms (e.g., new investors receiving *pari passu* liquidation preference with previous investors) as competition among private equity firms to make investments into this sector continues to heat up.

For a private equity investor with sufficient commercial leverage, the key challenge often lies not in convincing the investee company or its Chinese shareholders to agree to adequate contractual terms, but rather in getting comfort that an enforceable remedy will be available in the event that the Chinese counterparty reneges on its contractual obligations. One potential antidote to the difficult enforcement environment onshore is to seek a means of enforcement offshore. An investor can get comfort if it obtains, for example, a personal guarantee of the Chinese founder backed by assets outside China, governed by New York or Hong Kong law and providing for arbitration in Hong Kong as a dispute resolution venue. Such a guarantee, however, is rarely available (because the Chinese founder may not have assets outside China), and even when potentially available, is often unacceptable to the founder. A more realistic alternative is for a private equity investor to seek the right to appoint a trusted nominee in a chief financial officer or similar position (who could monitor an investee company's financial dealings and compliance with its covenants to its shareholders). An investor may also seek co-signatory rights over the target company's bank account, in which case an independent third party (the bank) will ensure that funds are not released other than for purposes agreed to by the investor.

iv Timetable

Among the US-listed going-private transactions that closed during 2017 and 2018, the parties took an average of five months from the announcement of the going-private proposal to reach definitive agreement, and a further three months on average from signing the definitive agreement to close the transaction. In 2020, we observed that the overall timetable for the going-private transaction has been shortened to three-to-five months. Typically, the pre-signing timetable is less predictable and to a large extent driven by negotiation dynamics, the finalisation of the members of the buyer consortium, arrangement of financing and the parties' willingness to consummate the deal, which in turn is affected by market conditions, availability of equity and debt financing, and various other factors. On the other hand, the post-signing timetable is typically largely driven by the SEC review process and shareholders' meeting schedule, and as a result is relatively more predictable. That being said, the going-private of Shanda Games took more than seven months from the signing of the definitive agreement to closing, substantially longer than what is typically required of the SEC review and shareholder approval processes, because of, inter alia, changes in the composition of the buyer consortium after signing. The going-private of Qihoo and Xueda Education each also took more than seven months from the signing of the definitive agreement to closing, reportedly because of the procedures required to obtain outbound investment regulatory approvals, to complete the conversion of renminbi financing into US dollars offshore and to complete other governmental formalities relating to relevant Chinese onshore buyers. While these are more exceptions than the norm, these transactions do flag for market participants the significant time and resource commitments required of participants in a going-private transaction, and the ever-changing dynamics of market demand and within the buyer consortium (including the time to have all the necessary funds in place), all of which are factors that could affect the timetable to completion.

v Exits

At the forefront of the privatisation wave in the US and Chinese markets, Focus Media achieved a 45.7 billion yuan backdoor listing on the Shenzhen Stock Exchange in December 2015 through Hedy Holding Co Ltd after a reverse merger, which followed Focus Media's 2013 going-private and de-listing from the United States led by a consortium of private equity investors. This deal represented the first re-listing of a once-NASDAQ listed company on the A-share market, and has blazed a trail for US-listed Chinese companies seeking to go private and thereafter relist in Chinese domestic market. Giant Interactive achieved an 13.1 billion yuan backdoor listing on the Shenzhen Stock Exchange in April 2016 through Chongqing New Century Cruise Co Ltd after a reverse merger, which followed Giant Interactive's 2014 going-private and de-listing from the US led by a consortium consisting of Giant Interactive's chair Shi Yuzhu and private equity investors, including Baring Private Equity Asia, Hony Capital and CDH Investments, making Giant Interactive the first once-US listed Chinese online game company getting relisted on the A-share market. Qihoo, after its largest going-private of a US-listed Chinese company to date, has received the Chinese securities regulatory authority's approval for a relisting in China under the new name of Technology 360 through back-door listing via Shanghai-listed Jiang Nan Jia Jie.

As US listings of Chinese companies picked up in 2016, the Shanghai-based logistics company ZTO Express, backed by Sequoia Capital as an early stage investor and Warburg Pincus, Hillhouse Capital Group, Gopher Asset and Standard Chartered Private Equity, who invested in the Series A financing of the company in 2015, raised US$1.4 billion in its listing on the NYSE in October 2016, making it the largest IPO by a Chinese company in the United States in 2016, and, after Alibaba, the second-largest in history for US IPOs of Chinese companies.

Another noteworthy IPO was the IPO of Beijing Baofeng Technology Co, Ltd on the Shenzhen Stock Exchange in 2015, which became the first-ever listing of a Chinese internet company on China's A-share market after phasing out its VIE structure, trailblazing a trend of Chinese technology companies tearing down VIE structures and seeking to be listed on Chinese or Hong Kong stock exchanges.

In the first quarter of 2020, because of the delay in the transaction progress as a result of the outbreak of the covid-19 pandemic, the number of exists failed to continue the growth in 2019, down 6.9 per cent YoY. Shanghai Stock Exchange STAR Market has been running well for one year, driving the number of IPOs of invested enterprises in the first quarter. IPO exits accounted for more than 70 per cent of the total exits. The number of M&A/backdoor transactions has decreased by more than 30 per cent compared with the same period of last year. Rare investment firms were adopting short-term arbitrage strategies. The return and internal rate of return (IRR) of value investors with longer investment horizon are generally higher.

IV REGULATORY DEVELOPMENTS

i Promulgation of the FIL and its implementation rules

The FIL, as the new fundamental piece of legislation for the foreign investment legal system, became effective on 1 January 2020. In the past, the laws relating to foreign investment in China, including the Law on Wholly Foreign-Owned Enterprises (which applies to WFOEs), the Law on Sino-Foreign Equity Joint Ventures (which applies to EJVs), the Law on Sino-Foreign Cooperative Joint Ventures (which applies to CJVs) (collectively, the Old

FIE Laws), various regulations and foreign investment administrative systems under the Old FIE Laws had been constantly updated and adjusted to adapt to the new challenges of the times. With the new FIL becoming effective, the Old FIE Laws and the old administrative systems thereunder were officially repealed simultaneously. It is also conceivable that the implementation of the FIL, the FIL Implementation Regulation and other new rules and regulations will lead to large-scale adjustments and clean-up improvements of various regulations based on decades-old regulatory approaches.

The FIL provides the fundamental rules for the promotion, protection and administration of foreign investment. It clearly stipulates the principle that domestic and foreign investment will receive equal treatment (e.g., at the investment access stage, the treatment of foreign investors and their investments are not to be less favourable than those of domestic investors and their investments). The foreign investment is subject to pre-access national treatment and a negative list managment system. The negative list approach is not new to the public as it was first introduced in China (Shanghai) Pilot Free Trade Zone (FTZ) in 2013; however, the FIL, which pre-empts local regulations, has established the negative list approach as a nationwide regime for all foreign investments in China.

In fact, the FIL has emphasised the promotion and protection of investment in special chapters, and among these chapters, the protection of intellectual property rights, the prohibition of compulsory technology transfers and the equal participation of foreign-invested enterprises in government procurement and in a standard setting are deemed as positive responses to recent public demands.

Another drastic change is that, under the FIL, FIEs in China are no longer categorised as WFOEs, EJVs and CJVs, and are instead equally subject to the provisions of the Companies Law, the Partnership Enterprise Law of PRC and other laws that are mainly applicable to domestic entities. Domestic enterprises and FIEs are established and operated in accordance with the unified rules. FIEs' corporate governance structures, shareholder or board meeting and voting procedures, equity transfers and profit distribution will be fully compatible with those of domestic enterprises. As such, the parties involved with or related to the foreign-invested enterprises may design and implement various arrangements and practices more flexibly. In the past, some Old FIE Laws contained certain corporate governance rules applicable to FIEs that were different to those set out under the Companies Law. FIEs that have corporate governance structures designed pursuant to Old FIE Laws need to convert their governance structures and amend their articles of association accordingly. The FIL allows such FIEs to keep their existing governance structure for a five-year transitional period, but they are required to complete the change to comply with the FIL by 1 January 2025. If FIEs fail to make the change within the transitional period, SAMR will not process other registration matters for these companies.

On 12 December 2019, China's State Council adopted the FIL Implementation Regulation, which took effect on 1 January 2020 together with the FIL. The FIL Implementation Regulation provides additional details and clarity on several general provisions and principles set out in the FIL. The FIL Implementation Regulation re-emphasises the national treatment principle for FIEs in several important areas, sets out FIEs' rights to participate in rule-making, standards formulation and government procurement, and also provides further details regarding expropriation of foreign investors' investments, protection of intellectual property, the new nationwide negative list system for administration of the establishment of and changes to FIEs, information reporting, and the transitioning of existing FIEs.

On 26 December 2019, the Supreme People's Court of PRC issued the Interpretation on Certain Issues Regarding the Application of the Foreign Investment Law (Interpretation), which also took effect on 1 January 2020. The Interpretation provides guidance on questions relating to the effectiveness and enforceability of foreign investment-related agreements, such as shareholder agreements, share transfer agreements and project contracts that may arise under the new negative list system. According to the Interpretation, with respect to agreements for investments in sectors that are not restricted under the negative list, Chinese courts should reject claims that an agreement is void or invalid if the parties have not completed relevant registration and approval procedures. However, with respect to agreements for investments in sectors that are prohibited by the negative list and agreements that violate the restrictions set out in the negative list, Chinese courts should uphold claims that the agreement is invalid.

On 1 January 2020, two separate notices issued by MOFCOM took effect and repealed various regulations, notices and other ministerial documents that had governed FIEs and their administration. However, with the abolition of the Old FIE Laws, a large number of regulations and rules have also been abolished or amended. The FIL Implementation Regulation stipulates that the FIL and the FIL Implementation Regulation shall prevail in the case of any discrepancy between them and any other regulations or rules (related to foreign investment regulation) that were effective prior to 1 January 2020. While this establishes the principle for resolving potential discrepancies, there may still be problems in practice without proper housekeeping of existing foreign investment regulations and rules. For the time being, relevant authorities such as MOFCOM, NDRC and the Ministry of Justice are all in the process of cleaning up existing regulations and rules. We expect the housekeeping of the implementation rules of the Old FIE Laws and other relevant regulations and rules to be completed and disclosed to the public relatively soon.

Some questions left unanswered by the FIL and the new FIL Implementation Regulation still exist and further clarification and improvement by the legislators and regulators are required.

ii Amendment to the Foreign Investment Catalogue

On 23 June 2020, NDRC and MOFCOM jointly issued the Foreign Investment Negative List (2020) (the 2020 Negative List), which took effect on 23 July 2020, and repealed, on the same date, the Foreign Investment Negative List (2019) (the 2019 Negative List). Prior to the issuance of the 2018 Negative List, foreign investment in China was subject to the Foreign Investment Catalogue (the latest edition was announced in 2017), which categorised industries as encouraged, permitted, restricted or prohibited for foreign investment. Similar to the 2019 Negative List, the 2020 Negative List only lists those industries subject to special management measures for foreign investment access, including 33 restricted and prohibited industries. Foreign investors in industries not listed in the Foreign Investment Negative List will be treated equally with Chinese investors in terms of market access. The 2020 Negative List reduces the number of industries restricted and prohibited for foreign investments from 40 (in the 2019 Negative List) to 33, further loosening restrictions on market access. The following are the key changes in some of the sectors that were the subject of particular focus:

a in the agriculture sector, the restriction that the breeding of new wheat varieties and seed production must be controlled by Chinese parties has been loosened up to that Chinese share shall not be less than 34 per cent;

b in the manufacturing sector, the prohibition against foreign investors investing in radioactive mineral smelting, processing and nuclear fuel production has been eliminated; the restriction that Chinese share in the manufacture of commercial vehicle shall not be less than 50 per cent has been eliminated;
c in the infrastructural facilities sector, the restriction that the construction and operation of urban water supply and drainage pipe networks for a city with a population of more than 500,000 must be controlled by Chinese parties has been eliminated;
d in the transportation logistics sector, the probation against foreign investors investing in air traffic control has been eliminated; and
e in the financial sector, the restriction that foreign share in the securities company, securities investment fund management company, futures company and life insurance company shall not exceed 51 per cent has been eliminated.

Similar to the 2019 Negative List, the 2020 Negative List also sets out a road map and timetable for the further opening up of the automobile sector in the next few years. According to these provisions, foreign shareholding restrictions on the manufacturing of passenger vehicles will be lifted by 2022; and the current restriction on foreign investors establishing more than two joint ventures manufacturing the same category of whole-vehicle products will also be removed by 2022.

On 27 December 2020, NDRC and MOFCOM promulgated the Catalogue of Encouraged Industries, which came into effect on 27 January 2021, and consists of a list applicable to the entire country, and another list only applicable to China's central, western and north-eastern regions and Hainan province. Compared with the list of the encouraged industries in the Foreign Investment Catalogue (2017 Edition) and the Foreign Investment Catalogue of the Priority Industries in Central and Western China (2017 Edition), the number of industries in which foreign investment is encouraged has been expanded. More than 80 per cent of the new additions and revisions of the nationwide list fall within the manufacturing sector, which supports and encourages foreign investment into high-end manufacturing, intelligent manufacturing, green manufacturing and relevant areas. The list applicable to central, western and north-eastern regions and Hainan province is more focused on labour-intensive industries and advanced and applied science industries, as well as the construction of supplementary facilities, encouraging foreign-invested businesses to move to those regions.

iii FIE information reporting system

Prior to 1 January 2020, FIEs needed to submit information through two channels: (1) the MOFCOM foreign investment record-filing system; and (2) the SAMR company registration system and enterprise credit information disclosure database. With the implementation of the FIL, these two channels have been unified. The scope and content of information required to be submitted by FIEs are limited to those deemed necessary by law and regulations.

To lay the groundwork for the administration of FIE establishment and changes, MOFCOM and SAMR issued the Foreign Investor Information Reporting Measures (the Reporting Measures) on 30 December 2019, and MOFCOM issued the Notice Regarding Foreign Investor Information Reporting Related Matters (the Reporting Notice) on 31 December 2019, both of which took effect on 1 January 2020. Under the Reporting Measures and the Reporting Notice, MOFCOM's record-filing system has been replaced by an information reporting system that applies to FIEs, foreign invested partnerships, foreign enterprises engaging in operation and production in China, and representative offices of foreign enterprises covering information reporting with respect to the establishment of FIEs and their subsidiaries, changes to FIEs and their subsidiaries, and annual reporting. Further details regarding the new annual reporting system for FIEs are set out in the Notice on Completing Annual Reporting 'Multiple Reports in One' Reform Related Work issued by MOFCOM, SAMR and SAFE on 16 December 2019. Information already submitted to SAMR by FIEs will be shared with MOFCOM and does not need to be separately submitted again by FIEs or foreign investors in information reports.

iv Pilot FTZs and the negative list market entry system

On 30 August 2020, the State Council released overall plans for launching three new FTZs in the provinces of Beijing, Hunan and Anhui, bringing the total to 21. These are located in Shanghai (2013), Guangdong, Tianjin and Fujian (2014), Henan, Hubei, Liaoning, Shaanxi, Sichuan, Chongqing and Zhejiang (2017), Hainan (2018), Shandong, Jiangsu, Guangxi, Hebei, Yunnan and Heilongjiang (2019) and Beijing, Hunan and Anhui (2020).

On 19 October 2015, the State Council issued the Opinion on the Implementation of the Negative List Market Entry System for the first time. The Opinion reflects the negative list approach that was first applied in China (Shanghai) Pilot FTZ, and that was later introduced to other pilot FTZs. With the enforcement of the FIL, the negative list approach has been adopted as a nationwide policy. However, the negative list that applies to the FTZs contains fewer restrictions than the nationwide list (which only applies to areas other than the FTZs).

On 23 June 2020, NDRC and MOFCOM jointly issued Special Administrative Measures (Negative List) on Foreign Investment Access to the Pilot Free Trade Zone (2019) (the 2019 FTZ Negative List), which is the seventh version of the FTZ Negative List and which took effect from 23 July 2020. The 2019 FTZ Negative List, which applies to the 21 pilot FTZs, from Shanghai to Yunnan, contains 30 restricted and prohibited sectors, and further opens up certain sectors that are still restricted or prohibited under the Foreign Investment Negative List applying to the territories outside the FTZs. The 2020 FTZ Negative List is a foreign investment list that sets out the foreign investment entry requirements for listed sectors not subject to national treatment with domestic investment in FTZs. Compared with its 2019 counterpart, the 2020 FTZ Negative List further deleted seven restrictive measures in several industries. The 2020 FTZ Negative List is slightly shorter than the Foreign Investment Negative List, and it is expected that the FTZ Negative List will continue to be the benchmark for future amendments of the nationwide Foreign Investment Negative List. In addition to the relaxation of foreign investment restrictions in the Foreign Investment Negative List as outlined above, the 2020 FTZ Negative List further relaxes the foreign investment restrictions in the following sectors as follows: the prohibition against foreign investors from investing in the application of processing techniques of traditional medicine decoction pieces, such as steaming, frying, cauterising and calcining and the manufacturing of Chinese patent medicine products with a secret formula has been eliminated.

v Outbound direct investment regulatory regime

The Chinese government promotes what it considers to be a healthy and sustainable development of outbound investments. Genuine and lawful outbound direct investment (ODI) deals continue to be supported, but the authorities on various levels have tightened the scrutiny of their authenticity and compliance in recent years. While genuine and lawful ODI transactions continue to be generally viable, delays in the outbound remittance of funds have increased. In addition, the regulators are closely monitoring certain types of restricted ODI deals, as set out above, and have reminded Chinese companies to make 'prudent' decisions. Under both ODI approval and filing procedures (see above in relation to NDRC approval and filing with MOFCOM), investors are required to provide a substantial amount of documentation and information to various authorities, and in both procedures the authorities have a certain degree of discretion in deciding whether to grant an approval or accept a filing. Chinese companies and their business partners should also keep in mind that material changes in an existing outbound investment shall be reported and may trigger another round of review by Chinese authorities.

V OUTLOOK

In light of increased scrutiny by regulators in both the United States and China, foreign private equity investors in China continue to increase their focus on rigorous pre-transaction anti-corruption due diligence, taking steps to ensure that any improper conduct has ceased prior to closing and implementing robust compliance policies after closing. In high-risk scenarios, such as transactions involving companies in which significant government interactions are necessary for their operations, the process can be complex and expensive.

Looking forward into 2021, we expect several key factors to impact the level of dealmaking activities for the year as compared to 2020. One key theme of the region going into 2021 is the extent to which the unpredictable trend of the political and economic uncertainties between the United States and China, combined with an increasingly tightened EU foreign investment-screening framework, will affect China's economic growth in the upcoming year. The continue magnitude of the impact that the covid-19 pandemic has had on China and globally is hard to predict, but the covid-19 situation will continue to create significant challenges to China's overall economic performance in 2021.

The regulatory landscape is also a key factor that may impact investment patterns. In terms of the foreign investment regulatory regime, the newly promulgated FIL and the corresponding foreign investor-friendly regulatory regime may attract more active foreign investments in the local market. On the other hand, foreign exchange control policy and availability will continue to play a significant role in leveraging the competitiveness of Chinese investors' participation in bidding for overseas assets, and will impact capital inflow and outflow. Separately, as China continues to broaden access to its market by foreign investors and improve the foreign investment environment, certain investors may find new opportunities in the reorganisation, consolidation and restructuring of SOEs, listed companies, financial institutions and top-notch start-up firms. However, other investors may shy away from dealmaking because of increased uncertainty in some traditional industries or over-leveraged sectors where the country's regulators may look to curb excessive capital inflow. Key industries such as information technology, healthcare, education and financial services are likely to become the driving forces from which significant transactions can be generated. Major technology companies such as Baidu, Alibaba, Tencent and Bytedance will continue to lead the way in industry, upgrading and consolidating given their active M&A appetite and the inherent need for sustainable growth. For certain industries or sectors in which national security, data protection or individual privacy is involved, the regulatory authorities may roll out new measures to ensure that appropriate protection mechanisms will be put into place. In other traditional sectors in which foreign investors' majority ownership is permitted for the first time, such as securities firms, life insurance companies and financial asset management companies, private equity investors could find new investment targets or collaborative opportunities for major transactions.

Following the buyout investment and going-private deals boom in 2020, 2021 is expected to be another strong year for IPO exits in China's domestic stock markets. In addition, there have been quite a number of going-private transactions involving Chinese companies listed in the Hong Kong Stock Exchange and the Singapore Exchange, and there could be increased market attention in 2021 on going-privates or takeovers of Chinese companies listed on these capital markets. Two remarkable transactions heading the trend of Hong Kong-listed companies going private were Blackstone's US$322.6 million takeover of property and construction group Tysan Holdings, which was launched in August 2013 and closed in January 2014, and Carlyle's take-private of Asia Satellite Telecommunications Holdings Ltd, in which Carlyle agreed to buy out General Electric's 74 per cent stake in the company for up to US$483 million, which was launched in December 2014 and closed in May 2015. In May 2016, Hong Kong-listed Wanda Commercial Properties' controlling shareholder, Dalian Wanda Group, on behalf of the joint offerors, including Pohua JT Private Equity Fund LP, Ping An of China Securities and Shanghai Sailing Boda Kegang Business Consulting LLP, made an offer valued at US$4.4 billion for the going-private of Wanda Commercial Properties, as the largest going-private offer in the history of the Hong Kong Stock Exchange. The deal was completed and Wanda Commercial Properties was delisted from the Hong Kong Stock Exchange in September 2016. A highlight of Chinese investors' take-private of a Singapore-listed company was the purchase of the Singapore-listed Global Logistic Properties (GLP), the largest warehouse operator in Asia, at US$11.6 billion, by a Chinese private equity consortium led by Chinese private equity firm Hopu Investment Management, Hillhouse Capital Group, Chinese property developer Vanke Group and the Bank of China Group Investment, supported by GLP chief executive Ming Mei: the deal was completed in early 2018. Market participants also continue to monitor court decisions in the Cayman Islands regarding dissenting shareholders, and how such decisions may further shape both the merger regime in that jurisdiction, where many Chinese companies listed overseas are incorporated, and the broader going-private market.

Chapter 4

GERMANY

Volker Land, Holger Ebersberger and Robert Korndörfer[1]

I OVERVIEW

i Deal activity

Driven by the covid-19 pandemic and the resulting global uncertainty, 2020 was a turbulent year for the German private equity (PE) industry. Following an unprecedented drop in deal activity in the second quarter of the year, it gained traction in the second half of 2020, ending up at a level that remained only slightly behind 2019. Looking at the aggregated numbers for 2020, the deal activity (buyouts) remained on a high level in terms of number of deals (193 deals), although this was a decrease compared with 2019 (223 deals).[2] However, the 2020 total buyout volume remained relatively stable with €34.1 billion (compared with €36.9 in 2019).[3] This was mainly because of a number of large-cap transactions, which included the sale of the elevator business of ThyssenKrupp to a consortium led by Advent, Cinven and RAG foundation for €17.2 billion, making it the largest leveraged buyout in Europe in a decade.[4]

The number of exits slightly increased from 68 in 2019 to 70 in 2020, whereas the value of the exits almost doubled from €7.6 billion in 2019 to €13.6 billion in 2020.[5] The largest exit was the sale of Bombardier Transportation by Caisse de dépôt et placement du Québec as financial investor and Bombardier Inc as parent company to Alstom.[6]

	2020 total	Half-year 1 (HY1) 2020	Half-year 2 (HY2) 2020
Total buyouts (billions of euros)*†	34.1	23.1	11.0
Total exits* (billions of euros)†	13.6	1.1	12.5
* See footnote 2; †rounded numbers.			

1 Volker Land and Holger Ebersberger are partners and Robert Korndörfer is an associated partner at Noerr PartGmbB.
2 Based on searches in the Mergermarket database for Private Equity buyouts, exits and secondary transactions in Germany.
3 ibid.
4 EY, Private Equity Der Transaktionsmarkt in Deutschland, 1. Halbjahr 2020.
5 See footnote 2.
6 ibid.

Large-cap companies continue to be of particular interest, especially for non-German PE investors. In 2020, seven PE transactions exceeded the €1 billion threshold, reaching an aggregate value of €27.9 billion.[7] Nevertheless, small and mid-cap transactions continue to constitute the predominant part of the deal activity of PE investors in Germany.

PE buyouts

General development

In 2020, the aggregate buyout value for PE transactions reached €34.1 billion.[8] Compared with 2019, in which a value of €36.9 billion was reached,[9] this is a slight decrease of approximately 7.6 per cent. The number of buyouts did, however, also decrease from 223 in 2019 to 193 in 2020.[10] This represents a decline of 13.5 per cent compared to 2019.

	2007*	2018†	2019*	2020*
Total buyouts by value (billions of euros)	22.7	17.9	36.9	34.1
* Mergermarket; †See footnote 4.				

Severe competition

Once again, PE in 2020 recorded a high market share compared to corporate buyers. It shows that regardless of the disruptions caused by the covid-19 pandemic, Germany remains a very attractive market for PE investors, and in 2020, PE transactions continued to be an important driver of the overall M&A activity in the market. With an aggregate PE deal activity of €34.1 billion in 2020, PE deals contributed around 49.5 per cent to the aggregate M&A deal activity to which strategic buyers contributed €34.7 billion in 2020.[11] This shows that the strong competition between strategic investors and financial sponsors for targets in Germany is continuing and PE investors continue to gain a larger share of the market. This might also be explained by the covid-19 pandemic, which led strategic buyers to reduce their M&A activity in terms of value by around 16 per cent compared to 2019.[12]

Large cap versus small and mid-cap

With an aggregate value of €27.9 billion, around 82 per cent of the overall buyout value can be attributed to seven large-cap transactions in Germany,[13] the largest being the acquisition of ThyssenKrupp's elevator business by a consortium including Advent, Cinven and RAG for €17.2 billion (which is also the biggest ever buyout in Germany), followed by the €2.8 billion takeover of Deutsche Glasfaser by EQT and Omers[14] and the acquisition of Flender Holding GmbH by Carlyle Group-managed funds for €2.025 billion from Siemens.[15]

7 ibid.
8 ibid.
9 ibid.
10 ibid.
11 www.ey.com/de_de/news/2020/12/ey-private-equity-markt-ueberwindet-corona-schock.
12 ibid.
13 See footnote 2.
14 ibid.
15 ibid.

The majority of the overall deal activity comprised small and mid-cap transactions with an aggregate value of approximately €6.9 billion. This only reflects the transactions that have a disclosed value; the actual value will be significantly higher as small and mid-cap focused PE investors tend to keep transaction values confidential.

Industries

The highest transaction value was achieved in the industrial sector (€17.6 billion), which was mainly driven by the acquisition of ThyssenKrupp's elevator business transaction with a value of €17.2 billion. The industrial sector is followed by automotive (€2.85 billion), telecommunications (€2.8 billion), healthcare (€2.05 billion) and information technology (€1.9 billion).[16] In 2019, the top two industries that attracted PE investors were chemicals (€6.8 billion) and information technology (€5.7 billion).[17]

In terms of number of deals, the information technology sector attracted the most financial sponsors, with 46 transactions in 2020. This is followed by the industrial (30 transactions), consumer products (24 transactions) and healthcare (19 transactions) sectors.[18]

The above figures show that sectors that were less affected by the covid-19 pandemic were the focus of M&A investors in the German market.

Exits (other than initial public offerings)

In 2020, the number of exits (trade sales) increased to 70 compared with 68 in 2019. The aggregate deal volume nearly doubled compared with 2019. The number of secondary buyouts decreased from 30 in 2019 to 24 in 2020, and the transaction value doubled compared with 2019 from €3 billion to €6 billion.

	2007*	2018†	2019*	2020*
Sales to strategic investors (value in billions of euros, and number)	16.8	4.5 (66)	7.6 (68)	13.6 (70)
Secondary buyouts (value in billions of euros, and number)	14.8	9.9 (49)	3.0 (30)	6.0 (24)
* Mergermarket; †See footnote 4.				

ii Operation of the market

Merger control proceedings

The covid-19 pandemic has posed significant challenges to the functioning of authorities and in particular to merger control proceedings, where strict deadlines apply.

On 13 March 2020, the Directorate-General for Competition at the European Commission (DG COMP) encouraged market participants to delay new merger notifications until further notice, emphasising the current 'complexities and disruptions'. While the European Commission had put in place certain measures to ensure business continuity, it also noted that 'difficulties in collecting information from third parties, such as customers, competitors and suppliers, in the coming weeks' are anticipated. From 16 March 2020, all European Commission staff in 'non-critical' roles, including case handlers, moved to remote working, which meant fewer opportunities for face-to-face engagement with notifying parties.

16 ibid.

17 EY, Private Equity Der Transaktionsmarkt in Deutschland, Gesamtjahr 2019.

18 See footnote 2.

In Germany, no such limitations were observed at the Federal Cartel Office (FCO). In a press release dated 17 March 2020, the FCO confirmed the functioning of its administration, but requested companies to consider whether any project or contemplated transaction could be presented and notified at a later date. However, fast-track decisions prior to the expiry of the statutory waiting period were less common in 2020, given the general reluctance (or inability) of national competition authorities.

Due to these challenges, and the need for staff to prioritise critical issues directly related to the covid-19 pandemic, the European Commission and national competition authorities also suspended statutory deadlines as practically needed and legally possible. The authorities can therefore request parties to submit information (request for information or RFI) with which the parties may not be able to fully comply; as a result, the proceeding may be put on hold for some time. In this climate, information requests can be a means to buy time in any transaction where the authorities (and the parties) consider it beneficial to suspend the waiting period. If no such suspension is possible, the situation may force parties to consider withdrawing notifications if the authorities do not feel confident to grant clearance of a transaction.[19]

The return of the MAC clause

In 2020, PE investors increasingly tried to include MAC clauses in transaction agreements (i.e., the right to rescind an agreed transaction in the event of a material adverse change (MAC) in the target's business operations or financial conditions). In the past, buyers invoked MAC clauses in Germany, for example, after the burst of the dotcom bubble in the early 2000s as well as during the financial crisis in 2007 and 2008. While MAC clauses have remained more common in the US market, in the past few years buyers in Germany were often less successful in implementing MAC clauses in transaction purchase agreements. This is because competitive auction processes do not allow for any contractual uncertainty in final bid documentation. However, MAC clauses could be agreed in restructuring or distressed M&A deals where the seller was dependent on a sale to a certain buyer at short notice.[20]

In the current covid-19 crisis, the MAC clause has come back in some transactions. Against the background of the first negative economic implications brought about by the rapidly spreading virus (e.g., many German companies were faced with interruptions in their supply chains, especially those producing in or being supplied from Asia; businesses in the travel and leisure industries were reporting substantial reductions in revenue in the light of cancelled events, travel restrictions or just general reduced travel and entertainment). Buyers were increasingly prompted to negotiate a MAC clause into transaction purchase agreements to have an (additional) option to walk away from a deal or at least reduce the purchase price. Often the sell side tried to specify the MAC event by stipulating quantitative hurdles (e.g., sales underperformance of 20 per cent or more compared to the business plan in a certain period). Particularly in locked-box deals (i.e., transactions with an economic cut-off date prior to signing), the absence of a MAC could be part of the ordinary course of business guarantee from the locked-box date onwards and, in addition, the non-occurrence of a breach of such a guarantee would be a condition for closing.[21]

19 www.noerr.com/en/newsroom/news/impact-of-the-coronavirus--pandemic-on-ma-transactions-subject-to-merger-control.

20 www.noerr.com/en/newsroom/news/transactions-in-times-of-corona-the-return-of-the-mac.

21 ibid.

In any case, whether a MAC clause may be triggered, even under the potentially dramatic circumstances caused by covid-19, depends on the specific wording of the MAC clause in question. For example, a MAC clause may often exempt a change in the general economic conditions (or the general conditions of the industry in which the target company operates) from the definition of a MAC. In such a case, a buyer would need to prove that the outbreak (or the increased spread) of covid-19 only resulted in a material adverse change for the target company's business, as opposed to a material adverse change in the economy in general or at least the target company's industry. It may also be difficult to prove that, with adverse business conditions because of the covid-19 pandemic already present at signing, the target's business has deteriorated even further to such a point that a material adverse change in the business can be assumed at the time of closing.

Even if a MAC clause does not provide for a specific definition of a MAC, the party looking to invoke the clause will need to prove the existence of an unforeseen adverse change that is material. The US courts have held that an adverse condition will only be considered a MAC if it is 'material when viewed from the longer-term perspective of a reasonable acquirer, which is measured in years' (*Akorn, Inc v. Fresenius Kabi AG*, C.A. No. 2018-0300-JTL (del. Ch. 1 October 2018). It is currently unclear whether German law would also require such a long-term view when determining whether an event is considered a material adverse change under an unspecified MAC clause.

In agreements governed by German law without a specific MAC clause, buyers could also try to raise the objection of interference in the basis of the transaction (Section 313 German Civil Code) as a result of the outbreak of the covid-19 pandemic to attempt to be relieved of their contractual obligations. While the chances of success of this objection depend on the specific case in question, courts supply very high hurdles to allowing deal terms to be modified and even higher hurdles for a right to rescind.[22]

Purchase price adjustments versus locked box

While the German M&A market was traditionally dominated by 'locked box' mechanics, a shift to 'purchase price adjustment' mechanisms was notable in 2020. A fixed purchase price – determined on the basis of reference accounts pre-dating the outbreak of the health crisis – did in many cases no longer correspond to the actual economic situation of the target and its business.

The impact of the covid-19 pandemic on many businesses was hard to predict. PE investors therefore pushed, especially in the early days and months of the coronavirus outbreak, for the use of a post-closing purchase price adjustment mechanism (also known as closing accounts) to determine the final purchase price payable by the investor. In this mechanism, the purchase price is adjusted by reference to a set of accounts showing the financial position of the target as of closing. There is then usually a euro-for-euro adjustment to the purchase price to the extent that the value of cash, working capital and liabilities is greater or less than a target figure agreed by the parties prior to signing the purchase agreement.

The accounting principles governing the preparation of the closing accounts have been heavily debated in some PE transactions. For example, sellers and buyers disagreed on the extent to which certain specific policies should be included to reflect the changing market conditions arising from the pandemic.

22 ibid.

Earn-out structures

There was also a rise in the number of earn-out clauses in PE deals in 2020. Although this tool may be seen as attractive under the current circumstances, its implementation in practice is often cumbersome. Earn-out clauses may be seen by the seller simply as a deferred payment, while the PE investor might be inclined to view the payment as fairly hypothetical.

However, when PE investors are unable to meet a seller's price expectations, an earn-out provision can help bridge the valuation gap. For the sellers, an earn-out provides an incentive to demonstrate their impact on future performance. The better the performance, the larger the eventual payoff.

II LEGAL FRAMEWORK

i Acquisition of control and minority interests

The legal framework for the acquisition of control and minority interest has not changed materially over recent years and is – apart from certain notarisation requirements under German law, the formalities of which are often accompanied by the raising of eyebrows by foreign investors entering the German market for the first time – in line with what can be expected from a highly sophisticated legal environment. The acquisition of shares is the most common structure, whereas asset deal structures are in most instances the means of choice in distressed scenarios. However, particularly in carve-out scenarios in larger corporate groups, mixed share and asset deal structures were also seen in 2020.

The acquisition of a target by a PE investor is often structured as leveraged buyout (LBO) and therefore financed partly by equity and debt. The PE investor typically acquires the target via a special purpose vehicle (SPV) that is held indirectly by the investing funds. In an acquisition structure aiming to acquire a German target, the most common legal form for the acquiring SPV (AcquiCo) is a German limited liability company (GmbH). In a typical LBO, the debt is taken up by the AcquiCo. Often, after closing, either the AcquiCo is merged with the target by way of an upstream merger or a fiscal unity is established between the AcquiCo and the target by way of a profit-and-loss pooling agreement. This optimises the tax structure and eases the repayment of the LBO debt out of the free cash flow of the target.

Equity-based incentive schemes (see Section I) are typically not implemented at the level of the AcquiCo but on a level higher up in the corporate structure.

ii Fiduciary duties and liabilities

The canon of fiduciary duties and liabilities is often stipulated in detail in shareholders' agreements, and is closely negotiated. This applies in particular to buyouts of owner-managed businesses in which the seller remains invested with a substantial stake. PE investors will generally not be involved in the day-to-day operations of their portfolio companies (e.g., by appointing portfolio managers as managing directors), but will rather influence the strategic decisions of the portfolio companies and provide industry know-how through seats on supervisory or advisory bodies. The specific legal framework generally depends on the legal form of the portfolio company and the investing entity. Most common are GmbH structures in which the parties are relatively flexible and can agree on a comprehensive regime of rights and duties of the investor. However, certain general statutory shareholders' duties have to be observed and cannot be derogated.

Capital maintenance

The PE investor has to observe the statutory capital maintenance rules stipulated in Sections 30, 31 and 43 of the German Limited Liability Companies Act (GmbHG) regarding GmbHs and Section 57 of the German Stock Corporation Act for German stock corporations. These provisions stipulate the general principle that the share capital (and, regarding stock corporations, any equity) may not be redistributed to the shareholders (whether openly or covertly). A breach of this principle can lead to repayment claims against the recipient and even personal liability of the management.

In particular, in LBO scenarios in which upstream guarantees and security are requested from the debt providers to guarantee and secure the loans granted to the acquisition vehicle, the capital maintenance rules have to be observed. Upstream guarantees and security can constitute a redistribution of the share capital, in the event that they are not covered by an adequate compensation claim against the borrower at the time of the issuance of the security.[23] In addition, the management of the securing company remains obliged to supervise the development of the adequacy of the compensation claim after the guarantees and security have been issued. In cases of an increased risk regarding the adequacy of the compensation claim, the management is obliged to request security or indemnification to avoid personal liability pursuant to Section 43 GmbHG. Several aspects and nuances of the requirements for fulfilling this obligation are disputed. In practice, the finance documents will generally contain certain limitation language to limit the personal liability of the relevant management.

German Capital Investment Code

The German Capital Investment Code (KAGB), which implements the Alternative Investment Fund Managers Directive[24] into German law, provides for regulatory restrictions regarding distributions to PE investors. Pursuant to Section 292(1) KAGB, distributions, capital reductions, share redemptions or acquisitions of treasury shares are restricted within the first 24 months of control having been obtained over a non-listed company by alternative investment funds. Specifically, distributions that are made to shareholders are prohibited (1) if the net assets according to the annual financial statements fall below the amount of the subscribed capital plus non-distributable reserves, or would fall below that amount as a result of such a distribution (Section 292 (2), No. 1 KAGB), and (2) if the amount of the distribution would exceed the amount of the result of the past financial year (plus profit carried forward and withdrawals from available reserves, less losses carried forward and legal and statutory reserves) (Section 292(2), No. 2 KAGB). Similarly, pursuant to Section 292, (2), No. 3 KAGB, repurchases of treasury shares by or for the account of the company that result in the net assets falling below the threshold specified pursuant to Section 292, (2), No. 1 KAGB are prohibited. Section 292 KAGB does not apply to small or medium-sized target companies (i.e., companies that have fewer than 250 employees, or a yearly turnover below €50 million, where the balance sheet total is below €43 million or where the target company is a real estate SPV (Section 287(2) KAGB; Section 2 of the annex to Recommendation 2003/361/EC)).

23 German Federal Court of Justice, NZG 2017, p. 344.

24 Directive 2011/61/EU dated 8 June 2011.

General fiduciary duties

Shareholders in a German GmbH are subject to a general duty of loyalty towards the portfolio company. The extent of this fiduciary duty depends on the circumstances of the individual case. In principle, shareholders may not induce the company to conduct business that is detrimental to the company or its business if they exert influence on management decisions. The general duty of loyalty may also include a non-competition and confidentiality obligation for the shareholders.

III YEAR IN REVIEW

i Recent deal activity

Despite the unprecedented challenges caused by the covid-19 pandemic, Germany continued to be an attractive market for PE investors in 2020. Although the overall number of buyout transactions decreased compared with the totals in 2018 and 2019, the aggregate disclosed value of buyout transactions remained relatively stable (see Section I).

ii Key terms of recent control transactions

Sale of ThyssenKrupp's elevator business to a consortium for €17.2 billion

ThyssenKrupp AG sold its elevators division to a consortium including Advent, Cinven and RAG for €17.2 billion, making it the biggest PE deal in Europe since 2007.[25] Reportedly, the group prevailed against a rival consortium comprising Blackstone Group Inc, Carlyle Group Inc and the Canada Pension Plan Investment Board. ThyssenKrupp Elevator is the world's fourth-largest elevator manufacturer behind United Technologies Corp's Otis, Switzerland's Schindler and Kone.[26]

Sale of Deutsche Glasfaser to EQT and OMERS for €2.8 billion

In February 2020, EQT Infrastructure and OMERS agreed to acquire Deutsche Glasfaser from KKR. Under KKR's ownership, Deutsche Glasfaser has become the fastest growing provider of gigabit internet connections through fibre-to-the-home (FTTH) in Germany. EQT Infrastructure will own 51 per cent in the combined group and OMERS will own 49 per cent.[27]

Sale of Flender Holding to Carlyle Group managed funds for €2.025 billion

In October 2020, global investment firm The Carlyle Group announced that it had agreed to acquire Flender Holding GmbH, a market leader in mechanical and electrical drive technology, from Siemens AG for €2 billion.[28] Headquartered in Bocholt, Germany, and active across 35 countries including Asia, Flender is a global leader in drive technology employing approximately 8,600 people and had sales of approximately €2.2 billion in

25 www.bloomberg.com/news/articles/2020-02-27/advent-consortium-is-said-to-near-deal-for-thyssen-elevators-k75174a1.

26 www.reuters.com/article/us-thyssenkrupp-m-a-privateequity-idUSKCN20L2O0.

27 www.businesswire.com/news/home/20200210005225/en/KKR-Sells-Deutsche-Glasfaser-EQT-OMERS.

28 www.carlyle.com/media-room/news-release-archive/carlyle-group-acquire-flender-siemens-ag-%E2%82%AC2-billion.

FY20.[29] The company's comprehensive product and service portfolio includes gearboxes, couplings and generators for a wide variety of industries.[30] The business is particularly strong in wind power, a sector benefitting from secular tailwinds given its increasing importance in the energy mix.[31]

Sale of Neuraxpharm to Permira for €1.6 billion

Permira has agreed to acquire a controlling shareholding in German pharmaceutical Neuraxpharm from UK PE firm Apax Partners, in one of the largest European pharmaceutical deals of 2020. Based in Düsseldorf, Neuraxpharm is focused on treatments for the central nervous system, providing medication for patients suffering from chronic neurological and psychiatric disorders including epilepsy, Parkinson's, Alzheimer's, depression and psychosis.[32]

IV REGULATORY DEVELOPMENTS

i Foreign investment[33]

On 22 January 2021, the Federal Ministry for Economic Affairs and Energy (BMWi) published a ministerial draft of the 17th revision to the Foreign Trade and Payments Ordinance (AWV), in which it proposes to tighten German foreign direct investment screening for the fourth time in less than 12 months. The stated aim of the draft revision is to adapt the AWV to the provisions of the just-amended Foreign Trade and Payments Act (AWG) and to transpose further aspects of the EU Screening Regulation (Regulation (EU) 2019/452 of 19 March 2019) into German foreign direct investment screening legislation. The draft revision also contains measures that substantially tighten and expand the scope of German foreign direct investment screening, making the draft revision highly controversial.

Among other things, the draft contains four key changes.

Firstly, the draft introduces a large number of additional case groups for target companies concerned in the context of the cross-sectoral review (under Section 4(1) No. 4 and Section 5(2) AWG and Sections 55 to 59 AWV). The creation of each new case group triggers a reporting obligation for investments from third countries, lowers the applicable threshold of controlled voting rights from 25 per cent to 10 per cent, involves a comprehensive prohibition on implementing transactions, leading to a presumption that there is a threat to German public order or security which can ultimately lead to a restriction on acquisition. The number of case groups is to be significantly expanded from currently 11 to 27. The focus of the new case groups is on future and key technologies such as artificial intelligence, autonomous driving, robotics and cyber-security.

Secondly, the sector-specific review (under Section 4(1) No. 1 and Section 5(3) AWG and Sections 60 to 62 AWV) is to be expanded to all acquisitions of companies that develop, manufacture, modify or have de facto control over listed military technology and equipment. This is in conjunction with a reporting obligation (in this area, for each foreign investment regardless of whether the buyer comes from the EU or from a third country), a lowering

29 ibid.
30 ibid.
31 ibid.
32 https://pe-insights.com/news/2020/09/22/permira-acquires-german-group-in-biggest-european-pharma-deal-of-2020/.
33 www.noerr.com/en/newsroom/news/further-tightening-of-investment-screening-in-germany-expected.

of the applicable threshold of controlled voting rights from 25 per cent to 10 per cent, a comprehensive prohibition on implementing transactions, and a presumption that that there is a threat to German public order or security. Especially with regard to target companies supplying corporate groups that in turn manufacture military goods, this appears to greatly increase the number of planned acquisitions that will need to be reported to the BMWi, well above the doubling already estimated in the draft revision. According to the applicable export control rules, the list of controlled items also includes 'specially designed' components for listed military equipment, and the authority responsible for export control in Germany, the Federal Office for Economic Affairs and Export Control, interprets the characteristic of special design in a very broad manner.

Thirdly, special attention should be paid to a provision according to which, for the first time since the inception of the German rules on foreign direct investment screening, the acquisition of rights of control and management are also to be taken into account. Previously, to determine whether the key thresholds of controlled voting rights were met or exceeded (10 per cent in the area of acquisitions requiring reporting or 25 per cent for all other acquisitions) the only factor taken into account concerned the nominal voting shares. According to the provision now envisaged, it will be enough for the acquirer to acquire a voting share below the relevant threshold if it is accompanied by the 'promise of additional seats or majorities on supervisory committees or in the management', the 'granting of veto rights in strategic business or personnel decisions' or simply the 'granting of rights to information', and thus in each case an influence on the domestic company is conveyed that corresponds to a voting share of 10 per cent or 25 per cent.

Finally, the revision contains a provision described as a 'clarification', which is meant to codify the BMWi's investment screening practice to date and which assumes that investment screening applies in the case of each share increase above the relevant thresholds of 10 per cent or 25 per cent. This is meant to apply even if the acquirer has received a certificate of non-objection or approval from the BMWi for its previous share purchases. Even minimal changes in shareholdings or intra-group restructurings can thus be reviewed by the BMWi and may have to be reported without any obvious need to do so.

The impact of the draft of the 17th revision of the AWV on transaction practice would be considerable. The BMWi itself estimates ('conservatively', it says) that the number of reportable acquisitions will rise by around 180 per year (150 in the cross-sectoral examination, 30 in the sector-specific examination). The BMWi has included in this estimate the fact that UK investors are now also subject to foreign direct investment screening as a result of Brexit.

ii Merger control

On 19 January 2021 the 10th amendment to the Act against Restraints of Competition (ARC) came into force.[34]

Under the 10th amendment to the ARC, both national turnover thresholds are being raised significantly. The first national turnover threshold is set at €50 million (previously €25 million) and the second national turnover threshold at €17.5 million (previously €5 million). The *de minimis* clause of Section 35(2) sentence 1 ARC has been deleted. According to this provision, a merger of a non-dependent undertaking with an annual global

34 www.noerr.com/de/newsroom/news/competition-outlook-2021.

turnover of less than €10 million did not have to be notified. As a result, such mergers still do not have to be notified in the future as such undertakings will stay below the new second national turnover threshold. The amendment will lead to a reduction of filings going forward.

The 10th amendment to the ARC also newly introduces a request to notify future mergers (Section 39a Draft ARC). The German Federal Cartel Office will be able to impose, by corresponding order, an obligation on undertakings, applicable for three years in each case, to notify all concentrations within certain sectors after a sector inquiry has been conducted, provided that the following requirements are met: the acquiring undertaking alone has to generate global revenue of more than €500 million and the target has a global revenue of more than €2 million, with Germany accounting for two-thirds of the target's revenues. There must be indications that future mergers would be likely to impair effective competition within the relevant industry sectors. The acquiring undertaking must hold market shares of at least 15 per cent within such industry sectors. The rule is aimed at gradual acquisitions that each in itself were previously not subject to merger control and lead to an extensive concentration of the market.

Examples of other relevant changes include: (1) the main examination proceedings (phase II) will be extended by one month to a total of five months from filing; (2) future electronic merger control filings can also be submitted by lawyers to a special electronic administration mailbox; (3) the obligation to notify the completion of a merger will cease to apply; (4) the minor market clause will be raised from €15 million to €20 million; (5) for mergers of press undertakings (not including broadcasters) the turnover multiplier will be reduced from eight to four; and (6) for certain mergers in the hospital sector, merger control regulations will temporarily not apply, under Section 186(9) ARC.

V OUTLOOK

PE investments will play a significant role in the German investment market in 2021. The vast amount of dry powder in the market, the low interest rate environment and the fact that a lot of companies hit by the covid-19 pandemic might be considered as valuable assets will induce PE investors to acquire attractive targets with a great upward potential. Given its stable political and legal environment, and as the leading economy in the EU, Germany will remain a very attractive market for inbound investments. Furthermore, the Joe Biden presidency will improve the trade relationship between the US and the EU and presumably ease existing tensions with China and Iran. However, as long as the covid-19 pandemic continues, the economic situation will remain challenging. Yet the general outlook for the German PE market looks bright and is likely to improve even further in the second half of 2021 given that various and effective vaccines against covid-19 have been authorised and are in use. Despite the ongoing economic recovery with an expected growth in GDP of approximately 2.8 per cent (according to a recent Organisation for Economic Co-operation and Development forecast), the German market will probably see an increase in distressed transactions in various industry sectors severely impacted by the covid-19 pandemic, such as the travel and hospitality markets. Investors focused on restructuring scenarios might have a busy 2021. Finally, since the United States has re-joined the Paris Climate Accord, one might also expect more investments in renewables given Germany's important role in this market.

Chapter 5

HONG KONG

Betty Yap, Edwin Chan and Ellen Mao[1]

I OVERVIEW

i Deal activity

The global pandemic following closely on the heels of the widespread social unrest and protests in 2019, coupled with the growing friction between mainland China and the United States, made investors and buyers more cautious, creating uncertainty for Hong Kong's role as a financial centre and gateway to the market, and prompting a slowdown in the Hong Kong economy as a result. According to Refinitiv, M&A transactions involving Hong Kong-based acquirers dropped by 13.7 per cent compared with 2019; the decline rate was less than the 18.4 per cent drop in 2018. Similarly, M&A transactions involving Hong Kong-based targets decreased by 13.5 per cent compared with the previous year, when the decline rate was also slightly below the 15.4 per cent decrease compared with 2018 to 2017.

For the private equity market, the number of outbound private equity investments by Hong Kong-domiciled private equity firms increased by 10 per cent. While the overall portion of Hong Kong private equity investments into the United States and mainland China have been decreasing over the years, 2020 saw a 3 per cent increase in the number of such investments in mainland China from Hong Kong compared with the previous year. In terms of industry, tech-related investment still tops Hong Kong investors' list over the years, with a steady increase in the number of private equity investments in semiconductors and other electronics (4 per cent of the overall private equity investment in 2020, compared with 1.7 per cent in 2017). In 2020, there was an uptick in the number of investments in the medical, health and life sciences sectors, from 10 per cent of the private equity investments in 2019 to 14 per cent in 2020.

In Hong Kong, private equity transactions decreased substantially in both volume and value compared with 2019. There were 31 private equity transactions in Hong Kong in 2020, representing a 16 per cent drop from the previous year. In the few years leading up to 2020, there had already been a steadily diminishing increase in private equity transactions. An opposite trend was observed in venture capital investments involving Hong Kong investors, with a 9 per cent increase in 2020 compared with 2019, in comparison to the 15.7 per cent decline in 2019 compared with 2018.

Private equity buyout transactions for control acquisitions involving a Hong Kong target decreased by 44 per cent to only nine transactions last year from 2019, contrasted with

1 Betty Yap is a partner and Edwin Chan and Ellen Mao are counsels at Paul, Weiss, Rifkind, Wharton & Garrison LLP. The authors wish to thank Andy Chan, Charity Cheung and Nicole Chan for their significant contributions to this chapter.

the 3.1 per cent drop in private equity buyout activity across the Asia Pacific region. There were 214 new growth equity (minority stakes) investments in 2020 – a 4 per cent increase from 2019. There were 183 control acquisition transactions, with the buyer acquiring a majority of the equity in a Hong Kong target, down 29 per cent from 2019, the largest percentage drop since 2016.

The number of investment firms founded in Hong Kong decreased year-on-year, a trend that escalated in 2019. In 2020, only four investment firms set up in Hong Kong, compared with seven in 2019. In stark contrast to the number of active initial public offerings (IPOs) in Hong Kong in 2020, there were three private equity exits in 2020. All three exits took place via trade sales last year and none of them exited via IPOs, as opposed to one trade sale and two IPOs in 2019. Details are laid out in Section III.iv. This is in contrast to the wider Asia Pacific region, where trade sale exits decreased significantly because of the limited level of in-person due diligence possible amidst the covid-19 pandemic.

ii Operation of the market

In line with international practice, various management incentive arrangements are used in Hong Kong private equity transactions with a view to retaining and incentivising key management members of the target company to achieve common financial objectives desired by the target company and the private equity sponsors.

Where management members are existing shareholders of the target company, it is common for private equity sponsors to enter into contractual arrangements to require such management members to reinvest a portion of their proceeds alongside the private equity sponsor in connection with its acquisition of the target company. Further, transfer restrictions, lock-up and standstill provisions imposed on the management members are commonly included in definitive transaction documents along with restrictive covenants such as non-compete and non-solicitation undertakings.

In the context of target companies listed on the Stock Exchange of Hong Kong Limited (the SEHK), equity incentive arrangements commonly take the form of a share option scheme governed by the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited (the Listing Rules). A share option scheme is generally a private contractual scheme and is often subject to a combination of stipulated performance target conditions and time vesting schedules to ensure alignment of management performance with the strategic goals of the target company.

In addition, Chapter 17 of the Listing Rules provides a transparent framework regulating a share option scheme's terms and conditions and implementation by imposing certain governance requirements and limits. Adoption of a share option scheme requires approval by shareholders[2] and the total number of shares issued or to be issued to a particular grantee on a rolling 12-month basis cannot exceed 1 per cent of the relevant class of shares.[3] In particular, grants to substantial shareholders (i.e., shareholders holding 10 per cent or more of the voting power of the target company) and independent non-executive directors, who otherwise approve grants to executive directors, fall under a lower threshold at 0.1 per cent (or HK$5 million in value).[4] Any grant exceeding these thresholds would require approval by

2 Rule 17.02(1)(a) of the Listing Rules.

3 Rule 17.03(4) of the Listing Rules.

4 Rule 17.04(1) of the Listing Rules.

independent shareholders. Further, the option price must be the market closing price on the date of grant (or the five-day average closing price immediately preceding the date of grant, if higher).[5]

Other forms of equity incentive arrangements, such as share award schemes and restricted share units plans, are also commonly seen in the market. Although share awards and restricted share unit schemes of target companies listed on the SEHK do not fall within the ambit of the Listing Rules, in the context of take private transactions, private equity sponsors should be mindful that equity incentive arrangements that give rise to special deals with favourable conditions not extended to all shareholders of the target company would require consultation and prior approval by the Executive Director of the Corporate Finance Division of the Securities and Futures Commission of Hong Kong (the Executive). Under the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Chapter 32 of the Laws of Hong Kong),[6] equity incentive plans made available to 'qualifying persons' of the target company such as its directors, employees, officers or consultants are generally exempt from the requirement for the issuance of a prospectus.

Private equity exits in Asia often adopt a dual track approach where a target company prepares for an initial public offering and concurrently pursues a possible trade sale process. To maximise sale proceeds and elicit the most favourable terms for sale, a trade sale is often conducted by way of auction. The flexibility and speed of the trade sale may be affected by pre-emption, tag-along or drag-along rights of the existing shareholders. Additionally, the timeline may be further extended where relevant consents, waivers or regulatory approvals need to be obtained or where debt financing arrangements are in place.

In the initial stage, a teaser containing preliminary information of the target company such as its business model, development strategy and principal assets is circulated to potential bidders to gauge interest and bids. Potential bidders who show interest will typically be required to sign non-disclosure agreements before being provided with the information memorandum setting out the auction bid process parameters and timeline. Further, potential bidders will also be given access to the data room to conduct their due diligence exercise and management interviews and onsite visits may be scheduled. Upon completion of the due diligence exercise, bidders will be required to submit a binding offer and proposed comments to the transaction documentation. Once the winning bidder is selected, the auction process is concluded with the execution of the transaction documents.

II LEGAL FRAMEWORK

i Acquisition of control and minority interests

M&A transactions involving public companies or companies listed on the SEHK are subject to the regulations of the Takeovers Code and Mergers and Share Buy-backs (the Takeovers Code), the Listing Rules and the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong). Where the target company operates in a regulated industry, any change of control may also require the consent of the relevant regulator. Although Hong Kong's merger control regime is only applicable to certain licensed companies in the telecommunications

5 Note 1 to Rule 17.03(9) of the Listing Rules.

6 Section 8 of Part 1 of the Seventeenth Schedule to C(WUMP)O.

and broadcasting sectors, the Hong Kong Competition Commission is reviewing the existing framework and a more expansive merger control regime in line with the trend across Asia is expected in the near future.

The privatisation process of a target company listed on the SEHK is typically effected by way of a general offer or a scheme of arrangement. Under a voluntary general offer, a bidder, typically a controlling shareholder, may make a general offer to all other shareholders to acquire their shares in the listed target company. Once the offeror and its concert parties have obtained acceptances that in aggregate represent 90 per cent in value of the shares for which the offer is made, the offeror may opt to compulsorily acquire the remaining shares held by the other shareholders who have not accepted the offer and the listed target company will then be delisted.[7] Further, pursuant to the Code, a mandatory general offer must be made by a person acting alone or in concert to acquire all the remaining shares of a listed target not already held by them when they acquire 30 per cent or more of the voting rights in the target company. To initiate the process of a general offer, a joint announcement by the offeror and the listed target confirming the offeror's firm intention to make the general offer is made. Within 21 days of this announcement, the offer document containing the terms of the offer accompanied by forms of acceptance must be posted to the shareholders of the target company. The board of the target company then has 14 days to issue a response document to set out its recommendation on the offer and the written advice obtained from its independent financial adviser. All offers must be conditional on the offeror having received acceptances in respect of shares that will result in the offeror reaching 50 per cent control of the target company, but may also be made conditional on acceptance level of shares carrying a higher percentage of voting rights.[8]

In contrast, a scheme of arrangement is a statutory corporate restructuring procedure whereby a court-sanctioned scheme of arrangement proposal is put forward by the target company to its shareholders.[9] The process is typically implemented by cancellation of all the issued shares (other than those shares held by the offeror) followed by issuance of new shares to the offeror. In return, the offeror will pay the consideration, which may take any form such as cash or other assets to the target company's former shareholders. The approval of the scheme must be obtained at a meeting of the disinterested shareholders and the approval threshold is not less than 75 per cent of the voting rights of the shareholders present and voting provided that votes cast against the scheme do not exceed 10 per cent of the voting rights attached to all disinterested shares, which has replaced the 'headcount test' – requiring approval by a majority in number of those voting at the meeting – that remains applicable in the Cayman Islands.

Private investment in public equity (PIPE) transactions are an alternative source of funding for target companies listed on the SEHK. In contrast to pre-IPO investments, in which special investor rights terminate upon completion of an IPO as required by SEHK guidance and policies, PIPE transactions in the form of convertible bonds or similar instruments offer some flexibility to allow investors to include rights and protections typically not enjoyed by individual shareholders of a SEHK-listed target company in the form of debt covenants. Support may also be obtained by private equity sponsors from controlling shareholders with respect to their board representation or observer rights at

7 Section 695 of, and Division 4 of Part 13 of, the Companies Ordinance.

8 Rule 30.2 of the Code.

9 Section 673 of the Companies Ordinance.

the target company. As many listed companies on the SEHK have a general mandate from their shareholders permitting them to issue up to 20 per cent of their issued share capital during the relevant year, the completion of a PIPE transaction can be a swift process taking weeks or even days, so long as the pricing requirements are complied with and there are no connected transaction implications. However, where the target company's general mandate is not available or the general mandate cannot be utilised for the proposed PIPE transaction, the target company would need to convene an extraordinary general meeting to obtain a specific mandate from its shareholders to proceed with the transaction. To ensure there is an open market for listed securities, unless the SEHK has exercised its discretion to accept a lower percentage at the time of the target company's listing, the public float threshold is set at 25 per cent. The shares held by a substantial shareholder (as defined above) will not be counted towards the public float. Thus, in structuring a PIPE transaction, the requisite public float would need to be maintained upon completion. Where the public float requirement has been breached, the SEHK has the right to suspend trading of the securities of the target company pending remedial action.

An investor acquiring more than 10 per cent of the voting power at the general meeting of a listed company or its subsidiary (other than an 'insignificant subsidiary') would become a connected person of that listed company. This renders any subsequent transaction between the investor (and certain categories of persons affiliated or associated with the investor) and the listed company or its subsidiaries subject to the Listing Rules regarding connected transactions,[10] making such transactions subject to disclosure and independent shareholder approval requirements, unless exemptions apply.

The structure of a cross-border private equity transaction or privatisation is usually determined in consideration of tax-related issues. As Hong Kong operates a territorial system of taxation, the profits tax rules apply equally to Hong Kong incorporated companies carrying on a trade or business in Hong Kong and overseas incorporated companies carrying on a trade or business in Hong Kong through a branch. For foreign companies listed on the SEHK, the tax costs of the transaction and the tax liabilities based on local jurisdiction tax laws and disposal rules should also be considered.

For a change of ownership or control of Hong Kong businesses in certain sectors, such as banking, insurance, financial services, telecommunications and broadcasting, consent is required from the relevant regulatory body. Save for only a few exceptions, such approvals apply equally to foreign and local investors.

The Competition Ordinance (Cap. 619 of the Laws of Hong Kong) establishes the competition law regime in Hong Kong. However, unlike many other major jurisdictions, it does not provide for general merger control provisions that apply across sectors, and the current scope of the merger rule applies only to the telecommunications sector. While local merger control rules have limited application, many Hong Kong businesses have substantial business and turnover in mainland China, meaning Chinese merger control rules may need to be considered in the acquisition of Hong Kong businesses. With Chinese companies making up a significant proportion of companies listed in Hong Kong, Chinese merger control review is also often a relevant consideration for public takeovers of Hong Kong-listed targets.

10 Chapter 14A of the Listing Rules.

ii Fiduciary duties and liabilities

In general, the sponsor as a shareholder of a portfolio company does not owe any fiduciary duties to other shareholders. It is entitled to exercise its vote in its own interests. However, if as a result of the decision arrived at by the general meeting, the company conducts its affairs and does an act that is unfairly prejudicial to the interests of another shareholder, that shareholder may petition to the court for remedies against the prejudicial conduct, which may include the payment of damages or an order for one shareholder to buy out the shares of another shareholder. If the portfolio company is listed on the SEHK, the sponsor must abstain from voting at a general meeting on any resolutions approving any transaction or arrangement in which it has a material interest.

A sponsor's representatives who are on the board of directors of a Hong Kong-incorporated portfolio company owe fiduciary duties to the company as directors. These fiduciary duties include a duty to act in good faith in the interests of the company as a whole, to exercise his or her powers for a proper purpose and to avoid conflicts of interests. The director must not use his or her position to gain an advantage for himself or herself or the sponsor. The director must also not use the company's property or information of which he or she becomes aware as a director of the company, except where the use or benefit has been disclosed to and approved by the company in a general meeting. In addition, the director has a statutory duty under the Companies Ordinance to exercise reasonable care, skill and diligence. The standard is a mixed objective and subjective test, with the care, skill and diligence that would be exercised by a reasonably diligent person with the general knowledge, skill and experience reasonably expected of a person carrying out a similar function, as well as the general knowledge, skill and experience that the director has. Where the company is insolvent, the director should take into account the interests of creditors in exercising his or her fiduciary duties.

Other obligations

If the portfolio company is listed on the SEHK, the directors will be required to comply with duties under the Listing Rules. In addition to the general duties of directors, there are also additional responsibilities under the Corporate Governance Code, such as the requirement to ensure that the director could devote sufficient time and attention to the company's affairs, to actively participate in regular board meetings and to participate in continuous professional development. Where the portfolio company is involved in a transaction with implications under the Takeovers Code, the directors will be subject to further duties, including that they should not make any commitments that would restrict their freedom to advise shareholders or to take any actions that would frustrate a bona fide offer.

In situations where a sponsor has an investment in a SEHK-listed portfolio company, or is conducting due diligence into a potential investment in a SEHK-listed company, it must ensure that it does not contravene the insider dealing provisions under the Securities and Futures Ordinance. Insider dealing takes place if a person receives, from a person connected with the company such as a director, information about the company or its listed securities that is not generally known but if known would be likely to materially affect the price of the securities, and deals in the securities of the company. If the sponsor's representative or other director discloses the inside information to the sponsor and the sponsor deals in the company's securities on the basis of the information, both the sponsor and the director will be regarded as engaging in insider dealing. Breach of the insider dealing provisions, as well as other forms of market misconduct under the Securities and Futures Ordinance, will result in civil and criminal liability.

In general, if the sponsor acquires an interest of 5 per cent or more of the voting rights of a SEHK-listed company, or its interest crosses a percentage threshold, it must submit a disclosure of interests form with the SEHK within three business days. The chain of controlled entities will need to be disclosed up to the ultimate controlling shareholder, and the information submitted will become publicly available. For a limited liability partnership, the Securities and Futures Commission (the SFC) expects that the general partner as well as any limited partner contributing more than one-third of the capital to the partnership should disclose their interests. Any person who fails to comply with the duty of disclosure or provides materially false or misleading information will commit an offence.

If a sponsor launches a takeover offer for a SEHK-listed company or enters into a transaction that falls within the Takeovers Code, it will need to comply with the requirements under the Takeovers Code. The Takeovers and Mergers Panel may impose sanctions on any person who breaches the Takeovers Code, which may include a public statement of criticism, a public censure, or a 'cold shoulder order' to withhold the facilities of the securities market from the person.

III YEAR IN REVIEW

i Recent deal activity

Notable private equity transactions in 2020 included the investment by China Resources Investment Management and Investcorp Holdings into City'super, a Hong Kong-headquartered lifestyle retail chain, having taken place at a time when the Chinese economy and its retail sector were rebounding off the back of strong consumer demand; the acquisition by a consortium fund led by Templewater, an alternative investment firm, of Citybus and New World First Bus, the largest franchised bus operations in Hong Kong, for US$410.2 million in the midst of the covid-19 pandemic; a US$70 million financing of Green Monday, a Hong Kong-headquartered social venture with focus on sustainable living; and Talon Esport, a Hong Kong-based professional esports organisation, which raised a seed round for expansion across the Asia Pacific region.

The year 2020 has seen a number of consortium offers launched or proposed. It is anticipated that the consortium structure may become more commonly used as private equity sponsors continue to seek investment opportunities to deploy the high level of dry powder raised. In particular, the controlling shareholders of Hong Kong-listed companies may increasingly team up with consortia, as we saw in Li & Fung Limited, IT Limited and CIMC-TianDa Holdings Company Limited, where, in each case, a consortium for making an offer was formed by the target's controlling shareholder and investors. Controlling shareholders may also turn to consortia as an alternative to banks for funding in take-private deals.

ii Financing

Given the complexity and bespoken nature of acquisition transactions, leverage financing is still the most popular option that we have seen in the market being adopted to finance acquisitions, in particular take-private deals.

In some deals, there are mezzanine facilities and senior facility structures, where the mezzanine lenders are funding part of the equity to be put into the vehicle that will act as borrower under the senior facilities. The minimum equity contribution at the senior borrower level could range from 30 per cent to 55 per cent of the total acquisition consideration (taking account of the size of the debts of the target group that are to be retired with the senior facilities).

Chinese banks have been progressively taking a more active role in leverage financing deals in Hong Kong directly or indirectly through their offshore branches, in particular in take-private transactions where the targets have significant operations in mainland China.

The margin could range from below 1 per cent plus the Hong Kong Inter Bank Offered Rate (HIBOR) or the London Interbank Offered Rate (LIBOR) to a two-digit number, depending on the creditworthiness of the sponsor and the assets that could be offered as security. In some of the agreements, there are margin step-down arrangements where the margin of the loans in a particular year will be gradually reduced along with the decrease of the leverage ratio (being the ratio of total debt-to-adjusted-EBITDA in respect of a relevant period, which is often 12 months). It is also common for arrangers to charge a one-off arrangement fee in leverage financing deals if the financing is provided in the form of syndicate lending. The arrangement fee is often expressed as a percentage to the total facility amount committed. It usually ranges from 1 per cent but rarely exceeds 2.75 per cent.

EBITDA, meaning the earnings before interest, taxation, depreciation and amortisation, is still the core parameter that drives a financial covenants test. For example, the most often tested financial covenants in a leverage financing deal, such as leverage ratios (as mentioned above) and interest cover (being the ratio of EBITDA to finance charge), are both tested against EBTDA. The opening leverage ratio roughly ranges between 4.5:1 to 5:1 and lenders may require the leverage ratio to be lowered gradually every half year or yearly to roughly 2.5:1.

iii Key terms of recent control transactions

Conditions for a private control transaction

Regulatory approvals and anti-trust approvals (for transactions involving targets in the telecommunications sector or groups with overseas operations) are typical conditions precedent to closing, if applicable. In competitive auctions, conditions may be limited to these only. In other transactions, closing conditions vary depending on the transaction and the parties' relative bargaining powers. Third-party consents having been obtained, no governmental action prohibiting the transaction and, where there is a long period between signing and completion, absence of material adverse change (MAC) impacting the target group, are some of the common conditions.

Conditions for a public takeover

As explained above, there are two main methods to obtain control of a Hong Kong public company – a general offer or a scheme of arrangement. A general offer can either be voluntary or mandatory. Except with the consent of the Securities and Futures Commission of Hong Kong, all offers must be conditional on the offeror receiving acceptances that result in the offeror and its concert parties holding more than 50 per cent of the voting rights in the target. A voluntary offer may be made conditional on a higher percentage acceptance level. Voluntary offers may also be subject to other conditions, provided that such conditions must not depend on judgments by the offeror or the target company or the fulfillment of which is in their respective hands. However, no such condition may be invoked to lapse an offer unless the circumstances that give rise to the right to invoke it are of material significance to the offeror in the context of the offer. Common conditions attached to a takeover offer include regulatory approvals, target shares remaining listed and traded up to the closing date, no material adverse change and no illegality. For a mandatory offer, the only condition that will normally be permitted is the 50 per cent acceptance condition.

An offer cannot be made subject to a financing condition. An offeror must have committed funding to satisfy its obligations under the offer at the time of the announcement of its firm intention to make an offer. As such, where an offeror takes out external debt financing to finance an offer, lenders will be expected to provide certainty of funds through limiting the number of events that would trigger a drawstop.

As the Takeovers Code prescribes a time period within which all conditions to a voluntary general offer or a scheme of arrangement must be satisfied, regulatory approvals that may not be obtained within the deadline are often set as pre-conditions instead of conditions to an offer.

MAC

The covid-19 pandemic has prompted parties to examine whether the pandemic has created a material adverse change at the target justifying termination by the buyer. In general, the threshold for a court to permit the invocation of a MAC clause to terminate a deal is high. In the context of a take-private transaction, the bar is even higher as the offeror generally cannot invoke a condition (including MAC) to lapse an offer under the Takeovers Code.

Price

Completion accounts remain the more common consideration adjustment mechanism, but locked-box mechanisms are becoming more common in the secondary buy-out market involving financial sellers or in auctions where price certainty is key.

Under the Takeovers Code, a break fee has to be *de minimis* (normally no more than 1 per cent of the offer value) and the target board and its financial adviser have to confirm to the SFC that the fee is in the best interests of the target's shareholders. In light of such regulatory constraints, break fees are uncommon in Hong Kong public M&A transactions.

Warranties and indemnities

As expected given the history of its legal system, Hong Kong M&A deals tend to follow UK market practice. For example, general indemnities are relatively uncommon and sellers tend to seek to disclose the entire contents of the documents contained in the disclosure bundle or data room against the representations and warranties. Subject to negotiation, time limit for claims for breach of representations and warranties is often limited to between 12 and 24 months after closing, although claims on fundamental and tax warranties tend to survive for longer periods. Seller liability is often capped at the total purchase price for breaches of fundamental warranties (such as title) and often around 15 to 30 per cent of the purchase price for other breaches. The increasing use of warranty and indemnity insurance may impact such terms and how they are negotiated. For example, where buy-side insurance is purchased, buyers may be more likely to resist data room disclosure as the insurance policy will usually deem the disclosures made in the data room as part of the general disclosures under the policy.

iv Exits

More exits have taken place by trade sales since 2018. In 2020, all exits occurred through trade sales, including the take-private of Li & Fung, a 114-year-old supply chain company which listed in Hong Kong in 1992, at HK$1.25 per share; and the privatisation of Haier Electronics Group by Haier Smart Home by way of a scheme of arrangement pursuant to which new H shares of Haier Smart Home were offered to the shareholders of Haier Electronics Group in exchange.

In 2019, according to Refinitiv, the sole trade sale exit by a private equity investor of a Hong Kong target was the sale of PSM International Holding Limited to Bulten AB, a leading supplier and manufacturer of fasteners in the automotive sector. In 2018, there were two exits effected through trade sales: New World Development purchased FTLife Insurance from JD Group, for HK$21.5 billion, regarded as the largest acquisition in the insurance sector in Asia at the time; and the merger of HKBN, a subsidiary of Metropolitan Light Company Limited, with WTT HK Limited (WTT), a company owned by TPG Capital and MBK Partners.

IV REGULATORY DEVELOPMENTS

The SEHK has primary regulatory oversight for transactions involving companies listed or applying to be listed on the SEHK. The SFC regulates takeovers, mergers and share buy-backs of public companies, as well as requirements under the Securities and Futures Ordinance relating to corporate disclosure, disclosure of interests and market misconduct. The SFC also regulates private equity firms that carry on regulated activities under the Securities and Futures Ordinance.

Where a transaction involves the sponsor acquiring a certain percentage interest in a company that operates in a regulated industry – for example, banking, securities, insurance, telecommunications and broadcasting – the sponsor will need to obtain approval from the relevant industry regulator. In addition, Hong Kong has a limited merger control regime for holders of telecommunications carrier licences, and the Competition Commission is the principal competition authority responsible for enforcing the regime.

i Profit requirement for listing

The SEHK published a consultation paper in November 2020 proposing to increase the minimum profit requirement for listing from HK$20 million for the most recent financial year and HK$30 million in aggregate for the preceding two financial years to HK$50 million or HK$75 million for the most recent financial year and HK$60 million or HK$90 million for the preceding two financial years.[11] If implemented, this would raise the minimum profit threshold that a portfolio company must achieve before the sponsor could exit through an IPO.

11 'Consultation Paper on the Main Board Profit Requirement' (27 November 2020).

ii Corporate weighted voting rights

Following the decision by the SEHK to permit listings of companies with weighted voting right (WVR) structures from 30 April 2018, the SEHK issued its consultation conclusions in October 2020 for listings of issuers with corporate WVR beneficiaries.[12] As a way forward, the SEHK will allow Greater China issuers with corporate WVR structures and listed on the New York Stock Exchange, NASDAQ or the Main Market of the London Stock Exchange on or before 30 October 2020 to list on the SEHK through a concessionary secondary listing route. The issuers must meet other criteria including that it is an 'innovative company', has a very high minimum market capitalisation and satisfies certain shareholder protection standards.

iii Statutory corporate rescue procedure

The Secretary for Financial Services and the Treasury has indicated that the Companies (Corporate Rescue) Bill is expected to be introduced into the Legislative Council in 2021.[13] The bill will introduce a statutory corporate rescue procedure where an independent third-party professional who is a Hong Kong certified public accountant or solicitor would be appointed as a 'provisional supervisor' to supervise the company for a period of time, during which there would be a moratorium on civil legal procedures against the company and its property. Where a sponsor is looking into investing in distressed companies, the proposed procedure would allow more flexibility for the company to conduct financial restructuring.

iv Limited partnership fund regime

The Limited Partnership Fund Ordinance came into operation on 31 August 2020 and established a regime to enable funds to be registered in the form of limited partnerships in Hong Kong. The regime was introduced specifically for use by investment funds in Hong Kong, and is part of the Hong Kong government's initiatives to promote Hong Kong as a premier fund hub in Asia. It is an opt-in registration scheme administered by the Companies Registry. The regime offers an alternative to funds domiciled in offshore jurisdictions.

v National security law

The National People's Congress of the People's Republic of China has promulgated the Law of the People's Republic of China on Safeguarding National Security in the Hong Kong Special Administrative Region (the National Security Law), which came into effect on 30 June 2020. The National Security Law prohibits secession, subversion, terrorist activities and collusion with a foreign country or external elements to endanger national security. Although the National Security Law does not directly regulate M&A activities, it has a broad extraterritorial scope of application. Parties should carefully review their business activities to ensure they do not unintentionally breach the requirements; for example, by providing financial or other assistance to persons for commission of the relevant offences.

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12 'Consultation Conclusions on Corporate WVR Beneficiaries' (30 October 2020).

13 'Legislative Council Panel on Financial Affairs – Legislative Proposals of the Companies (Corporate Rescue) Bill' (23 October 2020).

V OUTLOOK

Hong Kong's economy is going through an uncertain period, having weathered both the social unrest in 2019 and the continuing pandemic, as well as the global publicity surrounding the enactment of the National Security Law. While China has rebounded strongly from the pandemic, Hong Kong's economic outlook is less certain, which may impact investment flow. However, given its status as a regional financial centre and an offshore RMB hub, Hong Kong has traditionally been a bridge, instead of a focal point, for investment into and out of mainland China. It would be a deviated analysis if we focused solely on the figures of investments involving Hong Kong-based targets, without taking into consideration Hong Kong's functional and integrated role to the economies surrounding it. The decline should not be analysed in a vacuum and would not be as significant if we take into account the transactions in the Greater China region.

Set against the decreased private equity activity in Hong Kong was a record annual high of 54 buy-outs of Hong Kong-listed companies as the weakened economy made for attractive valuations for listed companies suffering from the economic downturn, a phenomenon already observed in 2019. According to Refinitiv data, the total value of such transactions stood at $22.5 billion for the year through mid-December 2020, representing a 160 per cent year-on-year increase, the highest since 2017. Despite the uncertainty, it is expected that private equity activity will pick up in 2021 as private equity investors, having been the beneficiary of the Chinese economy's rapid recovery, will continue to look for bargains in the public markets as depressed valuations present opportunities.

Chapter 6

INDIA

Raghubir Menon and Taranjeet Singh[1]

I OVERVIEW

The year 2020 brought the covid-19 pandemic along with other headline-grabbing challenges like global geopolitical tensions, lockdowns, trade wars, the India–China military stand-off, presidential elections in the United States, slowing consumption growth in core sectors, stress in the banking and lending space. However, despite the uncertainty resulting from the covid-19 pandemic, macroeconomic outlook and geopolitical situations, deal values in 2020 nearly retained parity with 2019, recording 1,268 transactions worth US$80 billion, up 7 per cent from 2019.[2]

As the pandemic wreaked havoc across economies, capital markets tanked, and foreign portfolio investors (FPIs) and foreign institutional investors (FIIs) pulled out nearly 1.18 trillion rupees from India in March. However, markets rebounded sharply and from June to December an influx of money came rushing back and Indian markets saw new inflows in excess of 2 trillion rupees. Massive inflow of capital, low interest rates and abundant liquidity also pushed India's stock markets to a record high, paving the way for India's expected road to recovery.[3]

Despite the pandemic and contracting economy, corporate India showed agility, adaptability and resilience in 2020. Despite the number of private equity (PE), venture capital (VC) and mergers and acquisitions (M&A) transactions dropping to the lowest in the last five years, the total value of PE, VC and M&A transactions in 2020 grew close to 12 per cent at US$83.6 billion.[4] Despite the challenges faced by the Indian economy in 2020, the investor community is still looking at India positively and deriving strength from policy decision-making that is targeted at either cleaning up the economy or making it easier to do business.

i Deal activity

General dealmaking trends in India in 2020

Despite a cautious approach of investors in the first half of 2020, India appears to be resilient and has demonstrated signs of a stable deals landscape. Consolidation and deleveraging, the race for dominance in industry, interest from very deep-pocketed long-term institutional investors, sovereign wealth funds (SWFs) and strategic buyers who have placed significant

1 Raghubir Menon is a partner and Taranjeet Singh is a principal associate at Shardul Amarchand Mangaldas & Co.
2 www.pwc.in/assets/pdfs/services/deals/deals-in-india-annual-review-and-outlook-for-2021.pdf.
3 www.vccircle.com/flashback-2020-a-limping-economy-and-high-human-cost-in-a-year-best-forgotten/.
4 www.vccircle.com/flashback-2020-coronavirus-drags-m-a-private-deal-volumes-to-five-year-lows/.

bets on India's growth story, and the availability of high-quality assets on the block, continued to act as key drivers for dealmaking in India in 2020. Consolidation to strengthen market position remained the primary trigger, driven by financial deleveraging, monetising non-core assets, entering new geographies and the faster pace of insolvency proceedings.

In terms of sectors, in 2020, telecom, retail, education and pharmaceuticals continued to attract investors and recorded increase in value invested. Because of continuing challenges for companies across manufacturing, infrastructure, financial services and real estate sectors, there has been significant increase in the banking sector and non-banking financial company (NBFC) crisis, the Indian stressed assets market continued to present prime assets at attractive valuations across a number of core areas for PE investors, SWFs and strategic buyers with an appetite for control deals, co-investment deals and platform deals.

PE funds such as Warburg Pincus, Goldman Sachs, Carlyle, General Atlantic, Blackstone, Silver Lake, Vista Equity and KKR, along with SWFs such as Public Investment Fund (PIF), GIC, Mubadala Investment Company, CPPIB, the Abu Dhabi Investment Authority and the Qatar Investment Authority, continued to demonstrate appetite for investing in Indian assets.

Mukesh Ambani's Reliance Industries Ltd, India's biggest private sector refiner, retailer and telecom operator left everyone with flurry of dealmaking in both M&A and PE space. It signed more than two dozen deals accounting for nearly US$31 billion.[5]

M&A dealmaking in India

The M&A space saw overall value rise by 15 per cent but number of deals slipped by about a third in 2020. The value of M&A deals stood at US$43.6 billion and total number of deals was a little above 620 compared to US$37.77 billion across 931 deals in 2019.[6] M&A deals rose in value despite the pandemic.[7]

As per the PwC report, domestic M&A activity in India accounted for nearly 50 per cent of total M&A activity at US$20.7 billion, followed by inbound M&As amounting to US$13.4 billion, whereas outbound M&A and other M&A activity amounted for US$3.8 billion and US$4.3 billion, respectively. The top 5 M&A deals struck during 2020 were as follows.[8]

Target	Buyer	Deal type	Deal value (US$ billions)	% sought
Jio Platforms Ltd	Facebook Inc	Inbound	5.7	9.9
Jio Platforms Ltd	Google LLC	Inbound	4.5	7.7
Future Enterprises Ltd (retail, wholesale, logistics and warehouse business)	Reliance Retail Ventures Ltd	Domestic	3.3	100
Lummus Technology	Haldia Petrochemicals Ltd and Rhone Capital LLC	Outbound	2.7	100
GMR Airports Ltd	Groupe ADP	Inbound	1.5	49

Reliance Group companies dominated the M&A dealmaking space in an unprecedented manner, which included Facebook and Google's investment of over US$10 billion in Jio

5 www.vccircle.com/dealmaking-in-2020-reliance-reliance-and-reliance-and-a-few-others.
6 www.vccircle.com/flashback-2020-m-a-dealmakers-try-their-best-to-keep-at-it-but-pandemic-messes-around.
7 See footnote 4.
8 See footnote 2.

Platforms Ltd and Reliance Retail Ventures Ltd's proposed acquisition of wholesale, logistics and warehousing businesses of Future Group for close to $3.4 billion. In the tech sector, cash rich Indian companies, Infosys, Wipro, Tech Mahindra and HCL Technologies remained active. In addition, Cognizant spent more than US$1.1 billion on various M&As in 2020. The healthcare sector saw 63 deals worth US$2.4 billion in 2020 compared to US$1.89 billion across 88 deals in 2019. Edtech was among the most active sectors in the start-up ecosystem, in which Byju's acquisition of coding-focused WhiteHat Jr for US$300 million proved to be highlight deal of 2020. Unacademy also struck at least five deals: Coursavy, Kreatryx, PrepLadder, Mastree and CodeChef. UpGrad made at least two acquisitions – recruitment and staffing firm Rekrut India Pvt Ltd, and test-preparation company The Gate Academy. In the e-commerce space Walmart-owned Flipkart acquired Mech Mocha and made investment in Aditya Birla Fashion and Retail Ltd.[9]

With a number of companies struggling to stay afloat, large strategic investments are expected in 2021 in the M&A space in India.[10]

PE dealmaking in India

The year 2020 saw record PE dealmaking activity in India and exceeded expectations with investments worth US$38.2 billion.[11] Consolidation to achieve size, scalability, new product portfolios and better operating models catapulted deal activity upward in the PE space. Similar to M&A space, Reliance Group companies dominated headlines in PE space too. Following Facebook, a consortium of funds, including TPG, KKR, General Atlantic, Silver Lake and other PE players and SWFs invested US$9.8 billion in Jio Platforms. Similarly, Reliance Retail Ventures saw investments worth over US$5.1 billion from similar PE and SWF investors. These investments catapulted growth stage and late-stage PE investments to an all-time high in India.[12]

The downward trend in deal volume continued in 2020; however, deal values surged upward in 2020 indicating an increase in the average ticket size. 2020 recorded 17 deals in the billion-dollar bracket compared to nine such deals in 2019.[13]

Though 2020 saw a decline in buyout deals, control still remain a key element in most transactions on account of concerns around transparency and governance-related issues. Control transactions eliminated trust deficit among investors and provided them with better control over operational and governance issues and the ability to maximise returns. In addition, it showcased a paradigm shift in the thought process of promoters, who are proving open to ceding control over operational aspects in an effort to boost growth. Consolidation, secondaries and deleveraging are expected to remain key drivers for PE activity in 2021. PE funds, SWFs and strategic investors sitting with significant volumes of dry powder will be willing to take a long-term view on their investments in 2021.

9 See footnote 7.
10 See footnote 2.
11 ibid.
12 ibid.
13 See footnote 2.

PE investments in 2020 by stage

Based on data collected from 1 January 2020 to 7 December 2020, as per a PwC report, growth investment deals were the major contributors to PE dealmaking in India and accounted for US$15 billion compared to US$8.5 billion in 2019, followed by late-state investments (US$11.2 billion in 2020 compared to US$9.6 in 2019). Buyouts witnessed a sharp decrease compared to 2019 and saw deals worth US$3.8 billion compared to US$12.2 billion in 2019, followed by early stage investments (US$1.1 billion compared to US$1.4 billion in 2019) and public investment in private equity (PIPE) deals (US$0.9 billion compared to US$2.5 billion in 2019).[14]

Exits

The downward trend in exits compared 2018 and 2019 continued in 2020. Exits reached an all-time low in the last six years. In 2020, exits declined 46 per cent in terms of value (US$6 billion versus US$11.9 billion in 2019) and 4 per cent in terms of volume (151 deals in 2020 versus 157 deals in 2019).[15]

ii Operation of the market

Equity incentive arrangements

The structure and terms of equity incentives are key considerations for private equity sponsors to ensure maximum alignment of interests and, ideally, value creation for all participants. In buyout transactions, a private equity firm often involves future management in the due diligence process and the financial modelling.

In India, common themes for equity incentive arrangements include the employee stock-option plan (ESOP), the employee stock-purchase plan (ESPP) (including sweet equity shares), stock appreciation right plans (SARs) or earn-out agreements. Allotment of shares under an ESOP or ESPP results in dilution of share capital, whereas SAR plans are non-dilutive in nature and are generally settled in cash.[16] A company can award shares subject to performance or time-based conditions.

An Ernst & Young (EY) survey shows that Indian organisations still prefer the conventional ESOP, where the Indian company typically sets up an employee trust to administer the ESOP scheme. Employees are given the option to purchase shares, and the option can be exercised after vesting in the employees. Usually, the share option plan is structured in such a way that shares will vest in tranches,[17] which may be arranged to align with a period covering the anticipated duration of the PE investment. Typically, a stock-based incentive plan runs from five to 10 years. The EY survey revealed that 88 per cent of respondents have a vesting period of one to five years and to exercise this right an employee normally gets one to five years. Generally, the share options are non-transferable and cannot be pledged, hypothecated or encumbered in any way. A company can prescribe a mandatory

14 ibid.

15 https://ivca.in/wp-content/uploads/2021/01/IVCA-EY-PEVC-Roundup-Annual-2020.pdf.

16 www.business-standard.com/article/pf/how-stock-based-incentive-plans-work-114041900805_1.html.

17 www.mondaq.com/india/x/590668/Employee+Benefits+Compensation/Employee+Share+Plans+In+India+Regulatory+Overview.

lock-in period with respect to shares issued pursuant to the exercise of the share option. On termination of employment, the employee typically must exercise the vested options by the date of termination and any unvested options will generally be cancelled.[18]

Under an ESPP, shares of the company are allotted up front to an employee, either at discount or at par, without any vesting schedule. In addition, the law also permits issuance of sweet equity shares, which are issued at a discount or for consideration other than cash to management or employees for their know-how, intellectual property or other value added to the company.

SARs entitle an employee to receive the appreciation (increase of value) for a specific number of shares of a company where the settlement of the appreciation may be made either by way of cash payment or shares of the company. SARs settled by way of shares of a company are referred to as equity-settled SARs. 'Phantom stock options' or 'shadow stock options' (phantom stock options), a popular nomenclature derived from usage for SARs, is a performance-based incentive plan that entitles an employee to receive cash payments after a specific period or upon fulfilment of specific criteria and is directly linked to the valuation and the appreciated value of the share price of the company.[19]

Because an ESOP has a vesting period, it is used as a means of retention, whereas an ESPP is mostly used to reward performance. Unlike an ESOP or ESPP, a SAR does not involve cash outflow from employees and is of advantage to an organisation by not diluting equity while, simultaneously, offering the economic value of equity to employees.[20] However, for employees seeking an equity stake in the company, phantom stock options may not be an attractive option. Prominent exit strategies for stock-based incentive plans typically entail employees selling shares on a stock exchange in the case of listed entities, and promoter buy-backs in the case of unlisted companies.[21]

Management equity incentives may also be structured through issuances of different classes of shares or management upside agreements (also called earn-out structures or incentive fee arrangements). Earn-out agreements are typically cash-settled or equity-settled agreements entered into between an investor and promoters or founders or key employees of a company, with the understanding that if the investor makes a profit on its investment at the time of its exit, a certain portion of the profit will be shared with those individuals. While giving investors a measure of control regarding the terms of an exit, earn-out agreements are also devised to incentivise and retain employees over a determined period. Typically, as the company is not a party to the agreement, the compensation is not charged to or recoverable from the company itself and these transactions are not reported within the ambit of related-party transactions entered into by the company. The policy argument against upside-sharing agreements is rooted in the possible conflict of interest between promoters and the management team in relation to the company and its other shareholders.[22]

In October 2016, the Securities and Exchange Board of India (SEBI), through its consultation paper on corporate governance issues in compensation agreements, observed

18 ibid.

19 https://economictimes.indiatimes.com/small-biz/legal/can-phantom-stock-option-be-the-best-way-to-incentivize employees/articleshow/52119814.cms.

20 See footnote 16.

21 ibid.

22 www.mondaq.com/india/x/758126/Shareholders/The+Ups+And+Downs+Of+UpsideSharing+Structures+In+India.

that upside-sharing arrangements are 'not unusual', but 'give rise to concerns' and 'potentially lead to unfair practices', so it was felt that such agreements are 'not desirable' and hence it was 'necessary to regulate' these. In January 2017, SEBI amended the Securities and Exchange Board of India (Listing Obligation and Disclosure Requirements) Regulations (the SEBI Listing Regulations) to regulate upside-sharing arrangements to insert a new Regulation 26(6) under which prior approval would be required from the board of directors and shareholders of the listed company through an ordinary resolution for new upside-sharing agreements between an employee, including key managerial personnel or a director or promoter, and a shareholder or third party, provided that existing upside-sharing agreements would remain valid and enforceable, if disclosed to Indian stock exchanges for public dissemination, approved at the next board meeting and, thereafter, by non-interested public shareholders of the listed company.[23]

Increased regulation on upside-sharing may also dampen enthusiasm for PIPE deals, where secondary transfers occur between significant shareholders and investors through the block window of an Indian stock exchange or off-market transactions. Pending policy review, Indian companies and other stakeholders can continue to explore upside-sharing structures subject to appropriate corporate disclosure norms, or explore alternative capital raising and exit options.[24]

Standard sales process

According to the 2018 EY 'Global Private Equity Divestment Study', almost 61 per cent of PE executives now determine the right time to sell as being 12 months before the exit; up from 35 per cent in the 2017 study. The percentage of PE funds relying on opportunistic buyers has fallen from 54 per cent to 21 per cent. PE funds are spending more time positioning the business for exit, with a sale strategy established well in advance. A similar trend is also being witnessed in India with PE investors getting more pragmatic and less opportunistic in selling assets. The PE/VC space witnessed record-high exits in 2018, and almost 85 per cent of these happened through strategic sales, which grew sevenfold from 2017, while open-market transactions fell by more than half in 2018.[25]

Dealmaking in India traditionally has remained relationship-driven, involving identifying the target with high-quality assets from a shallow pool of assets in market; winning deals; establishing synergy with the founders, promoter groups or management; agreeing on indicative valuation; and entering into a term sheet. The term sheet has to be prepared in sufficient detail to cover the major terms and conditions of the potential transaction, indicative timelines for negotiation, finalisation and execution of definitive documents and completion of legal, technical and financial due diligence, and exclusivity and no-shop obligations.

23 SEBI has been proactive in dealing with management incentive agreement issues by either issuing: (1) show-cause notices to listed entities for violations of corporate governance and disclosure-related norms for failing to report incentive fee agreements (as in the case of PVR Limited in November 2016); or (2) informal guidance on a variety of issues, including applicability of amendment to the SEBI Listing Regulations to management incentive agreements entered into with eligible employees of unlisted subsidiaries of listed entities (as in the case of Mphasis), and requirement of approval in cases of revival of a dormant incentive plan upon listing of an entity (as in the case of PNB Housing Finance Limited).

24 See footnote 22.

25 www.ey.com/Publication/vwLUAssets/ey-pe-capital-briefing-april-2018/$FILE/ey-pe-capital-briefing-april-2018.pdf.

However, in the past few years there has been a paradigm shift towards a controlled competitive bid model run by investment bankers or similar intermediaries. A seller-led trade sale process by way of a controlled auction has the following distinct advantages: (1) bringing more potential buyers into the sale process; (2) creating competition among bidders, thereby encouraging higher prices and more favourable terms for the seller (including diluted warranty and indemnity packages); (3) satisfaction of corporate governance concerns by maintaining transparency of process and superior control over flow of information, and securing the highest reasonably attainable price for stockholders; (4) ability to shorten the timelines by creating deadlines for submission of bids and completing various phases of the sale process; (5) a greater degree of confidentiality; and (6) greater control over the process. Given the lack in depth of quality assets in the Indian market, controlled bid processes have potential to unlock value and have fetched astronomically high valuations for highly desirable assets that were put on the block, thus making an auction sale an attractive option for the selling stakeholders.

A typical bid sale process usually entails the following stages.

Phase I

Phase I can be broken down into the following steps:

a an approach is made by the seller's investment banker to potential buyers;

b a non-disclosure agreement is executed;

c a process letter is circulated setting out in detail bid process rules, timelines and parameters for indicative proposals;

d an information memorandum is circulated to potential bidders setting out meaningful information about the target (i.e., business model, strategy for growth, principal assets and limited financial information) to generate interest and elicit meaningful bids; and

e on the basis of the information memorandum, the bidders submit an indicative proposal to the seller.

Phase II

On the basis of a review of indicative proposals, bidders who are shortlisted to progress to the next phase of the sale process will be allowed access to the data room to conduct legal, financial environmental, technical and anti-corruption and anti-money laundering diligences. Preparation of vendor due diligence reports, by the target or the seller, for bidders is typically a standard feature in bid situations, so that the bidder's own legal due diligence process can be conducted more effectively and in a timely manner. It is not unusual to see buyers in these situations conducting limited top-up due diligence checks to verify findings in the vendor due diligence reports.

Shortlisted bidders are also provided access to management presentations, interviews with the management and participation in site visits. Templates of definitive agreements prepared by the seller are also provided to the shortlisted bidders for submission of their proposed mark-ups along with a final proposal by the end of this phase.

Phase III

Upon evaluating the final bids, and after taking into consideration the price offered and the terms bidders are seeking under the definitive documents, the process concludes with the selection of the winning bidder.

Phase IV

The final phase of an auction process is similar to a standard sale process where parties negotiate, finalise and execute definitive agreements.

One of the key drivers in negotiations is zeroing in on the structure that minimises tax leakage and is in compliance with the regulatory framework governing the transaction. After definitive documents are executed, deals may require regulatory approvals (typically these approvals may be from the governmental bodies, the Reserve Bank of India (RBI), SEBI or the Competition Commission of India (CCI), or any sector-specific regulator (such as insurance, telecoms or commodities exchanges). The parties can proceed to closing upon satisfaction or waiver, to the extent permissible, of all conditions precedent (including obtaining any third-party consents). Closings typically occur anywhere between a few weeks (where no regulatory approvals are required) to three months (where regulatory approvals are required) after the execution of definitive documents. Depending on the management of the process, complexity of the sale assets, sector, the deal size, the parties and regulatory complexity a deal cycle may take anywhere between three months and one year from the signing of indicative offers of interest or longer where substantial restructuring of assets under a court-approved process has to be undertaken or where regulatory approvals are required.

In recent years, emerging trends in sale processes in India have included: (1) institutional sellers not providing any business warranties except in buyouts or control deals; (2) parties utilising escrow mechanisms and deferred consideration for post-closing valuation adjustments and indemnities; (3) target management facilitating trade sales and providing business warranties under contractual obligations under shareholders' agreements or on account of receiving management upside-sharing incentives; (4) use of locked-box mechanisms; and (5) buyers arranging warranty and indemnity insurance to top up the diluted warranty and indemnity package obtained in competitive bid situations to ensure that meaningful protection is obtained.

II LEGAL FRAMEWORK

i Acquisition of control and minority interests

Primary targets

Unlisted public companies or private limited companies are the most frequent investment targets for PE in India. The inefficiencies of India's delisting regulations, the inability to squeeze out minority shareholders and the inability of PE investors to obtain acquisition finance are the primary reasons that make completion of 'going-private' deals unattractive for PE investors in India.

Key deal structures

Acquisition in India can be structured: (1) by way of merger or demerger; (2) in the form of an asset or business transfer; (3) in the form of a share acquisition; or (4) as a joint venture. Commercial and tax advantages are key considerations for investors when determining the structure for the transaction.

Legal framework

The principal legislation governing share purchases, slump sales, asset and business transfers, joint ventures and liquidation and insolvency in India comprises the Companies Act 2013 (the Companies Act), the Indian Contract Act 1872 (the Contract Act), the Specific Relief Act 1963 (the Specific Relief Act), the (Indian) Income Tax Act 1961 (the Income Tax Act), the Competition Act 2002 (the Competition Act) and the Insolvency Code. The Companies Act is the primary piece of legislation and governs substantive formation and operational aspects of companies, the manner in which securities of companies can be issued and transferred, mergers and demergers, and approval and effectuation of slump sales.

Matters of taxation in connection with acquisitions and disposals are governed by the provisions of the Income Tax Act. Under the Indian tax regime, a non-resident investor is subject to tax in India if it receives or is deemed to receive income in India; or income accrues or arises or is deemed to accrue or arise in India. A classical amalgamation and demerger is a tax-neutral transaction under the Income Tax Act, subject to the satisfaction of other specified conditions.

The inter se rights of the contracting parties are governed by the Contract Act and the Specific Relief Act. To achieve greater certainty on the enforceability of shareholders' rights, the transaction documents of a significant number of transactions are governed by Indian law. However, transaction documents governed by foreign law and subject to the jurisdiction of foreign courts are also common. Arbitration governed by rules of major international arbitration institutions (including the International Chamber of Commerce, the London Court of International Arbitration and the Singapore International Arbitration Centre) with a foreign seat and venue is the most preferred dispute resolution mechanism for PE investors in deals in India.

The CCI is the competition regulator and has to pre-approve all PE transactions that fall above the thresholds prescribed in the Competition Act. While evaluating an acquisition, the CCI would mainly scrutinise whether the acquisition would lead to a dominant market position, affecting competition in the relevant market.

Transactions involving listed entities or public money are also governed by various regulations promulgated by the securities market regulator, namely SEBI. Direct and indirect acquisitions of listed targets that meet predefined thresholds trigger voluntary or mandatory open offers, in accordance with the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations 2011. In addition, parties have to careful about price-sensitive information that may be disclosed in conducting due diligence on targets, as any sloppiness may have implications under the Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations 2015. Clearances from SEBI are also required in transactions involving mergers or demergers of listed entities. Listing of securities is governed by the SEBI Listing Regulations.

The Banking Regulation Act 1949 specifically governs the functioning of banks and NBFCs under the supervision of the RBI in India. Relevant foreign exchange laws (including the Foreign Exchange Management Act 1999 and the rules and regulations framed under it (FEMA)) will apply in any cross-border investment involving a non-resident entity. Investments involving residents and non-residents are permissible subject to RBI pricing guidelines and permissible sectoral caps. PE investors typically invest in equity or preferred capital, or a combination of both via primary or secondary infusion. FEMA recognises only equity and equity-linked instruments (compulsorily convertible to equity) as permitted capital instruments. All other instruments that are optionally or not convertible into equity or equity-like instruments are considered debt and are governed by separate regulations.

FEMA pricing guidelines prohibit foreign investors from seeking guaranteed returns on equity instruments in exits. However, with the advent of newer instruments such as rupee-denominated debt instruments (also known as masala bonds) and listed non-convertible debentures (NCDs), PE investors are utilising combination deals with hybrid structures to limit their equity exposure and protect the downside risk, by investing through a combination of equity or preferred capital and NCDs.

Furthermore, there are several pieces of sector-specific federal-level legislation, environmental legislation, intellectual property legislation, employment and labour legislation, and a plethora of state and local laws. One piece of legislation that is key in finalising deal dynamics is the Indian Stamp Act 1899, which provides for stamp duty on transfer or issue of shares, definitive documents, court schemes and the conveyance of immovable property.

ii Structuring and entry routes for offshore investors

Foreign investment is permitted in a company and limited liability partnership (LLP) subject to compliance with sectoral caps and conditions. However, foreign investment is not permitted in a trust, unless the trust is registered with SEBI as a VC fund, alternative investment fund (AIF), real estate investment trust (REIT) or infrastructure investment trust (InvIT). Foreign PE investors can invest in India through the following entry routes.

Foreign direct investment route

Investors typically route their investments in an Indian portfolio company through a foreign direct investment (FDI) vehicle if the strategy is to play an active part in the business of the company. FDI investments are made by way of subscription or purchase of securities, subject to compliance with the pricing guidelines, sectoral caps and certain industry-specific conditions. Such investments are governed by the rules and regulations set out under the FDI consolidated policy (the FDI Policy), which is issued every year by the DPIIT of the Ministry of Commerce and Industry, and the Foreign Exchange Management (Non-Debt Instruments) Rules 2019 (the NDI Rules). The NDI Rules supersede the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations 2017. While the changes introduced in the NDI Rules were originally not substantial, many changes have been pushed through individual amendments since its notification. Under the NDI Rules, in line with the erstwhile regulations, any investment of 10 per cent or more of the post-issue paid-up equity capital on a fully diluted basis of a listed company will be reclassified as an FDI. In addition, the NDI Rules stipulate that the pricing of convertible equity instruments is to be determined upfront and the price at the time of conversion should not be lower than the fair value at the time of issue of such instruments.

The NDI Rules have been aligned with the SEBI (Foreign Portfolio Investors) Regulations 2019 (the FPI Regulations) to provide that an FPI may purchase or sell equity instruments of an Indian company that is listed or to be listed subject to the individual limit of 10 per cent (for each FPI or an investor group) of the total paid-up equity capital on a fully diluted basis or the paid-up value of each series of debentures, preference shares or share warrants issued by an Indian company. The aggregate holdings of all FPIs put together (including any other permitted direct and indirect foreign investments in the Indian company) are subject to a cap of 24 per cent of the paid-up equity capital on a fully diluted basis or the paid-up value of each series of debentures, preference shares or share warrants. Such aggregate limit of 24 per cent can be increased by the concerned Indian company to up to the sectoral cap or statutory ceiling (as applicable) by way of a board resolution and a shareholders' resolution (passed by 75 per cent of the shareholders).

Previously, any investment in excess of the sectoral caps or not in compliance with the sectoral conditions required prior approval of the Foreign Investment Promotion Board (FIPB). In furtherance of its announcement in 2017, the government abolished the FIPB in 2017. In place of the FIPB, the government has introduced an online single-point interface for facilitating decisions that would previously have been taken by the FIPB. Upon receipt of an application for an FDI proposal, the administrative ministry or department concerned will process the application in accordance with a standard operating procedure (SOP) to be followed by investors and various government departments to approve foreign investment proposals. As a part of its initiative to ease business further, the SOP also sets out a time limit of four to six weeks within which different government departments are required to respond to a proposal. More than three years on, there is very little information in the public domain about the proposals processed by the SOP.

FPI route

Foreign investors who have a short investment horizon and are not keen on engaging in the day-to-day operations of the target may opt for this route after prior registration with a designated depository participant (DDP) as an FPI under the FPI Regulations. The FPI Regulations supersede the erstwhile SEBI (Foreign Portfolio Investors) Regulations 2014 (the 2014 Regulations). The process of registration is fairly simple and ordinarily it does not take more than 30 days to obtain the certificate.

In 2014, to rationalise different routes for foreign portfolio investments and create a unified and single-window framework for foreign institutional investors, qualified institutional investors and sub-accounts, SEBI, the security watchdog, introduced the regulations on FPIs. In December 2017, SEBI, with the intention of providing ease of access to FPIs, approved certain changes to the FPI Regulations, which included: (1) rationalisation of fit-and-proper criteria for FPIs; (2) simplification of the broad-based requirement for FPIs; (3) discontinuation of requirements for seeking prior approval from SEBI in the event of a change of local custodian or FPI DDP; and (4) permitting reliance on due diligence carried out by the erstwhile DDP at the time of the change of custodian or FPI DDP. In addition, with a view to improve ease of doing business in India, a common application form has been introduced for registration, the opening of a demat account and the issue of a permanent account number for the FPIs.

In 2019, SEBI introduced the FPI Regulations, with certain important changes from the 2014 Regulations, including:

a the re-categorisation of FPIs into two FPI categories (rather than the three FPI categories under the 2014 Regulations);

b for investment in securities in India by offshore funds floated by an asset management company that has received a no-objection certificate under the SEBI (Mutual Funds) Regulations 1996, registration as an FPI will have to be obtained within 180 days of the date of the FPI Regulations;

c the broad-based requirement (where the fund was required to be established by at least 20 investors) for certain categories of FPIs has been done away with;

d the concept of opaque structure has now been removed from the FPI Regulations such that the entities that are incorporated as protected cell companies, segregated cell companies or equivalent structures, for ring-fencing of assets and liabilities, can now seek registration as FPIs under the FPI Regulations. Having said that, under the 2014 Regulations, where the identity of the ultimate beneficial owner was accessible, such entities could fall outside the scope of opaque structures and, hence, obtain registration as an FPI. Similarly, while the concept of opaque structures has been removed under the FPI Regulations, FPIs need to mandatorily comply with the requirement of disclosure of beneficial owners to the SEBI; and

e the total investment by a single FPI, including its investor group, must be below 10 per cent of a company's paid-up equity capital on a fully diluted basis. If this threshold is exceeded, the FPI needs to divest the excess holding within five trading days of the date of settlement of trades resulting in the breach. The window of five trading days allows FPIs to avoid any change in the nature of their investments. However, upon failure to divest the excess holding, the entire investment in the company by the FPI (including its investor group) will be treated as an FDI, and the FPI (including its investor group) will be restricted from making further portfolio investments in terms of the FPI Regulations.

The clubbing of investment limits for FPIs is done on the basis of common ownership of more than 50 per cent or on common control. As regards the common-control criteria, clubbing shall not be done for FPIs that are: (1) appropriately regulated public retail funds; (2) public retail funds that are majority owned by appropriately regulated public retail funds on a look-through basis; or (3) public retail funds whose investment managers are appropriately regulated. The term 'control' is understood to include the right to appoint a majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of shareholding or management rights, by shareholders' or voting agreements, or in any other manner.

Under the original FPI regime, Category I FPIs were restricted to those who were residents of a country whose securities market regulator was either a signatory to the International Organization of Securities Commission's Multilateral Memorandum or had a bilateral memorandum of understanding with SEBI. Hence, Category I FPIs were essentially governments and related entities or multilateral agencies and were perceived to be the highest-quality and lowest-risk investors.

Pursuant to the reclassification of FPIs, the entities that have been added to Category I, inter alia, are: (1) pension funds and university funds; (2) appropriately regulated entities, such as insurance or reinsurance entities, banks, asset management companies, investment managers, investment advisers, portfolio managers, broker dealers and swap dealers; (3) appropriately regulated funds from Financial Action Task Force member countries; (4) unregulated funds whose investment manager is appropriately regulated and registered as a Category I FPI; and (5) university-related endowments of universities that have been in existence for more than five years. In addition, the Category II FPI includes all the investors not eligible under Category I, such as individuals, appropriately regulated funds not eligible as Category I FPIs and unregulated funds in the form of limited partnerships and trusts. An applicant incorporated or established in an international financial services centre (IFSC) is deemed to be appropriately regulated under the FPI Regulations.

Foreign venture capital investor route

The foreign venture capital investor (FVCI) route was introduced with the objective of allowing foreign investors to make investments in VC undertakings. Investment by such entities into listed Indian companies is also permitted subject to certain limits or conditions. Investment through the FVCI route requires prior registration with SEBI under SEBI (Foreign Venture Capital Investors) Regulations 2000 (the FVCI Regulations). Investment companies, investment trusts, investment partnerships, pension funds, mutual funds, endowment funds, university funds, charitable institutions, asset management companies, investment managers and other entities incorporated outside India are eligible for registration as FVCIs. One of the primary benefits of investing through the FVCI route is that FVCI investments are not subject to the RBI's pricing regulations or the lock-in period prescribed by the SEBI (Issue of Capital and Disclosure Requirements) Regulations 2018.

Pursuant to the FVCI Regulations, FVCIs must register with SEBI before making investments. The process typically takes 20 to 30 days from the date of application. To promote job creation and innovation, the RBI allowed for 100 per cent FVCI investment in start-ups. In this regard, the NDI Rules also allow FVCIs to purchase equity, equity-linked instruments or debt instruments issued by an Indian start-up, irrespective of the sector in which it is engaged, subject to compliance with the sector-specific conditions (as applicable). Previously, only investment in the following sectors did not require prior approval of the securities regulator:

a biotechnology;
b information technology;
c nanotechnology;
d seed research and development;
e pharmaceuticals (specifically in terms of discovery of new chemical entities);
f dairy;
g poultry;
h biofuel production;
i hotels and convention centres with a seating capacity of over 3,000; and
j infrastructure.

iii Tax structuring for offshore investors

Double-taxation avoidance treaty

The tax treatment accorded to non-residents under the Income Tax Act is subject to relief as available under the relevant tax treaty between India and the country of residence of the investor. If the non-resident is based in a jurisdiction that has entered into a double-taxation agreement (DTA) with India, the double-taxation implications are nullified and the Indian income tax laws apply only to the extent they are more beneficial than the terms of the DTA, subject to certain conditions. PE investors structure investment through an offshore parent company with one or more Indian operating assets. Understandably, the primary driver that determines the choice of jurisdiction for offshore investing vehicle is a jurisdiction that has executed a DTA with India. Hence, the Income Tax Act is a major consideration in the structuring of a transaction. India has a comprehensive tax treaty network with over 90 countries, providing relief from double taxation.

Historically, non-resident sellers whose investments were structured through jurisdictions having a favourable DTA with India were exempt from paying capital gains tax.

Because capital gains and dividends are non-taxable, and because of their low income tax rates, Mauritius, Singapore, Cyprus and the Netherlands were the most preferred jurisdictions of investors planning to invest into Indian companies.

The government renegotiated the DTAs with Mauritius, Singapore and Cyprus to provide India with the right to tax capital gains arising from transfer of shares acquired on or after 1 April 2017, with the benefit of grandfathering provided to investments made up until 31 March 2017. Equity shares acquired by investors based in Mauritius and Singapore on or after 1 April 2017 but transferred prior to 1 April 2019 will be taxed in India at 50 per cent of the applicable rate of domestic Indian capital gains tax; and shares acquired on or after 1 April 2017 but transferred on or after 1 April 2019 will be taxed at the full applicable rate of domestic Indian capital gains tax. Equity shares acquired by PE investors based in Cyprus on or after 1 April 2017 will be taxed at the applicable rate of domestic Indian capital gains tax. Compulsory convertible debentures and non-convertible debentures are exempt from capital gains tax for investors based in Mauritius, Singapore and Cyprus.

At present, except for a few DTAs (such as the Netherlands and France, subject to conditions), India has the taxing rights on capital gains derived from sales of shares. Having said that, in most Indian tax treaties, with limited exceptions (such as the United States and the United Kingdom), capital gains derived from hybrid, debt and other instruments (excluding shares in an Indian resident company) continue to be exempt from tax in India.

GAAR

To curb tax avoidance, the Indian government introduced the General Anti-Avoidance Rule (GAAR) with effect from 1 April 2017, with provision for any income from transfer of investments made before 1 April 2017 to be grandfathered. The GAAR has been introduced with the objective of dealing with aggressive tax planning through the use of sophisticated structures and codifying the doctrine of 'substance over form'. It is now imperative to demonstrate that there is a commercial reason, other than to obtain a tax advantage, for structuring investments out of tax havens. Once a transaction falls foul of the GAAR, the Indian tax authorities have been given wide powers to disregard entities in a structure, reallocate income and expenditure between parties to the arrangement, alter the tax residence of the entities and the legal situs of assets involved, treat debt as equity and vice versa, and deny DTA benefits.

Place-of-effective-management risk

Under the Income Tax Act, tax residence forms the basis of determination of tax liability in India, and a foreign company is to be treated as tax resident in India if its place of effective management (POEM) is in India. Pursuant to the POEM Guidelines,[26] POEM is 'a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are in substance made'.[27] Where a foreign company is regarded to have a POEM in India, its global income is taxable in India at the rates applicable to a foreign company in India (at an approximate effective rate of 41.2 to 43.26 per cent). Accordingly, PE investors must exercise caution when setting up their fund management structures, and in some cases their investments, in Indian companies.

26 Circular No. 6 of 2017 dated 24 January 2017 issued by the Central Board of Direct Taxes.

27 ibid.

iv Fiduciary duties and liabilities

The Companies Act has for the first time laid down the duties of directors of companies in unequivocal terms in Section 166, and these include:

a to act in accordance with the articles of the company;
b to act in good faith, and to promote the objects of the company for the benefit of its members as a whole and in the interests of the company, employees, shareholders, community and the environment;
c to act with due and reasonable skill, care, diligence, and exercise independent judgement;
d not to be involved in a situation that may lead to a direct or indirect conflict or possible conflict of interest with the company;
e not to achieve or attempt to achieve any undue gain or advantage either for themselves or for their relatives, partners or associates (a director who is found guilty of making undue gains shall be liable to compensate the company); and
f not to assign their office to any other person (such an assignment, if made, shall be void).

To mitigate the risk of nominee director liability arising out of any statutory or operational issues in target companies, PE investors should ensure that the investee company specifies one of the directors or any other person to be responsible for ensuring compliance with all operational compliance requirements. To safeguard their interest and avoid undue liability, it is advisable that directors attend meetings regularly and adopt a precautionary approach, including taking the following steps:

a be inquisitive, peruse agendas for unusual items and seek additional information in writing, if necessary;
b ensure that disagreements or dissenting views are recorded in the minutes;
c act honestly (with reasonable justifications) and report concerns about unethical behaviour, actual or suspected fraud or violation of the company's code of conduct or ethics policy;
d seek professional advice, engage external agencies, if the situation demands it;
e regularly provide requisite disclosures of interests or conflicts, consider excusing oneself from participation in proceedings in cases of conflict; and
f include indemnity provisions in the letter of appointment and seek directors and officers liability insurance from the company to protect against malicious actions.

PE investors, as shareholders in target companies, do not have any additional fiduciary duties or any restrictions on exit or consideration payable for a fund domiciled in a different jurisdiction (from a fiduciary duty or liability standpoint). The inter se contractual rights between shareholders and the company shall be governed by the respective shareholders' agreements. However, in a control deal, for certain regulatory purposes a majority investor may be viewed as a promoter.

III YEAR IN REVIEW

i Recent deal activity

Piggybacking on US$17.3 billion investment in Reliance Group entities, 2020 recorded PE/VC investments of US$47.6 billion,[28] out of which PE accounted for nearly US$39.2 billion,[29] at par with investments in 2019. As per the report by IVCA,[30] whereas the number of PE deals decreased, 2020 surpassed all records for PE investment by value:

Year	2016	2017	2018	2019	2020
Number of deals	892	858	984	1012	812
Amount (US$ billion)	13.5	23.9	36.4	36.3	39.2

Key investors, LPs, SWFs, pension funds

Along with the usual segment leaders Blackstone and KKR, West Asian sovereign wealth funds and a couple of US buyout firms proved to be the top bulls in the PE investment segment in India. Saudi Arabia's PIF led the ranking for top PE investor in 2020.[31] Together, 11 PE investors invested or committed at least US$25 billion in 2020.[32] The number of investors who invested more than US$1 billion doubled in 2020 and there were eight investors who put in at least US$2 billion to work in India in 2020.[33] India continued to attract the interest of very deep-pocketed SWFs, traditional limited partners (LPs) and pension funds, and all stepped up their investments in India. SWFs have been a part of over 18 per cent (in terms of value) of the PE investments made in the country between 2014 and 2018. SWFs from across the globe, particularly Canada, Singapore and Abu Dhabi were a part of some of the largest PE transactions in 2020. As per the VCCircle Report, the following were the top PE/SWF investors in India in 2020:[34]

PE/SWF investor	Amount (US$ billion)	Number of deals
Saudi Arabia's PIF	3.3	4
Blackstone	3.2	7
KKR	3.05	5
Silver Lake	2.8	3
Brookfield	2.8	6
GIC	2.2	15
Mubadala	2.05	2
ADIA	2.0	6
Vista PE	1.5	1
General Atlantic	1.4	6
Carlyle	0.85	3

28 See footnote 15.
29 https://ivca.in/wp-content/uploads/2021/01/IVCA-PE-VC-Report-2020-Annual.pdf.
30 ibid.
31 www.vccircle.com/flashback-2020-wealth-funds-newcomers-jostle-with-old-timers-in-top-pes-list.
32 ibid.
33 ibid.
34 ibid.

SWFs have been relatively active in the telecom and retail space in 2020, having been a part of some of the largest deals in this segment. These funds have not only demonstrated interest in energy, financial services, real estate and infrastructure, but have also jumped on the tech start-up bandwagon, demonstrating their growing risk appetite and possibly spurring competition with the VC community.[35]

LPs that were traditionally funds of funds and used to funnel money to PE and VC funds, are increasingly investing directly in companies, often co-investing with the general partners (GPs) backed by them. The key reasons behind the paradigm shift over the past five years include: (1) additional flexibility and choice in investment decisions; (2) the healthy growth potential of the Indian market on account of improvement in ease of doing business and the reform agenda; (3) co-investments help in improving returns, as LPs do not pay any incremental management fee to the GPs; and (4) availability of significant funds for direct investment in India. Direct investment by LPs in the Indian market over the past 10 years adds up to in excess of US$20 billion. GIC, Temasek, International Finance Corporation, Abu Dhabi Investment Authority, CPPIB, Caisse de Dépôt et Placement du Québec (CDPQ) and PSP are a few of the very deep-pocketed LPs who have invested in Indian markets. The number of PIPE deals has seen strong growth on account of large LPs investing directly in India. GIC turned out to be the most active investor. Apart from sealing a mega deal for an India-dedicated platform for warehousing, it backed The Phoenix Mills, Midspace REIT and Prestige Estate in 2020.[36]

Key trends, sectors and deals

Despite the slowdown in deal volume, deal value saw an upward trajectory, indicating an increase in the average ticket size. Nineteen of the 85 large deals in 2020 were on account of investments in Reliance Group entities (worth US$17.3 billion). Other large deals in 2020 include Brookfield's acquisition of commercial space from RMZ Corp US$2 billion, Blackstone's purchase of the rental income assets of Prestige Group for US$1.5 billion, Blackstone's acquisition of Piramal Glass Private Limited for US$1 billion, Thoma Bravo's US$729 million buyout of Majesco Limited's US business, a US$660 million investment in food delivery platform Zomato by Tiger Global, Fidelity and a group of other investors and Baring PE Asia's buyback of shares of Hexaware Limited worth US$565 million.[37] In another trend in 2020, investors showed preference for 'quality companies' by shelling out large cheques for minority stakes without board seats or voting preferences. KKR, TPG and General Atlantic settled for a below 10 per cent stake in Reliance entities.[38]

Following the success story of the Blackstone-backed first REIT[39] in India in 2019, REIT offerings from Mindspace and Brookfields were lapped up by investors. Further, InvITs also attracted significant attention from the investors in 2020. In one of the mega deals of 2020, PIF and ADIA invested US$1 billion to acquire a 51 per cent stake in Digital Fibre Infrastructure Trust (DFIT), the InvIT established by Reliance.

35 www.pwc.in/assets/pdfs/publications/2018/deals-in-india.pdf.

36 www.vccircle.com/flashback-2020-office-assets-defy-work-from-home-to-emerge-as-real-estate-winners.

37 See footnote 15.

38 www.vccircle.com/flashback-2020-how-three-pe-trends-gained-momentum-in-virus-scarred-year.

39 An investment vehicle that owns and operates real estate-related assets and allows individual investors to earn income produced through ownership of commercial real estate without actually having to buy any assets.

As per the EY Report, in 2020 almost all sectors recorded a sharp decline in value invested, except telecom, retail, education and pharmaceuticals. Telecom was the top sector with US$10 billion invested across 13 deals (10 times increase year-on-year (yoy)), followed by retail and consumer sector with US$6.6 billion invested across 46 deals (6.7 times increase yoy), real estate with US$5.2 billion invested across 31 deals (16 per cent decline yoy), financial services with US$4.8 billion invested across 144 deals (47 per cent decline yoy), technology with US$3.3 billion invested across 140 deals (16 per cent decline yoy), pharmaceuticals with US$3.0 billion invested across 36 deals (2.4 times increase yoy), e-commerce with US$2.5 billion invested across 112 deals (47 per cent decline yoy) and education with US$2.1 billion invested across 71 deals (2.7 times increase yoy). The infrastructure sector, that received the highest value of investments in 2019, received US$5.0 billion across 30 deals in 2020 (64 per cent decline yoy).[40]

The top five PE transactions (by deal value) in 2020 were:[41]

Company	**Investor**	**Deal value (US$ billions)**	**Stake (%)**
Jio Platforms	Public Investment Fund of Saudi Arabia, Vista Equity Partners, Mubadala Investment, ADIA, Silver Lake, L Capital Asia, TPG Capital, Qualcomm Ventures, KKR, Intel Capital and General Atlantic	9.9	N/A
Reliance Retail Ventures	Mubadala Investment, ADIA, TPG Capital and GIC	2.6	4.25
Reliance Retail Ventures	Silver Lake, KKR and General Atlantic	2.5	4.25
RMZ Corporation	Brookfield	1.9	N/A
Reliance Retail Ventures	Public Investment Fund of Saudi Arabia	1.3	2.04

As per the EY Report, other notable PE deals in India in 2020 (excluding Reliance group, infrastructure and real estate) were:[42]

Company	**Investor**	**Sector**	**Stage**	**Deal value (US$ millions)**	**Stake (%)**
Piramal Glass Private Limited	Blackstone	Industrial Products	Buyout	1,000	100
Majesco Limited (US Business)	Thoma Bravo LP	Technology	Buyout	729	100
Zomato Private Limited	Tiger Global, Kora and others	E-commerce	Growth Capital	660	N/A
Hexaware Technologies Limited	Baring PE Asia	Technology	PIPE	565	29
Natrol LLC (US unit of Aurobindo Pharma)	New Mountain Capital	Pharmaceuticals	Buyout	550	100
Think and Learn Private Limited (Byju)	General Atlantic, Own Ventures, Tiger Global, Silver Lake Management and others	Education	Growth Capital	496	NA
JB Chemicals and Pharmaceuticals Limited	KKR	Pharmaceuticals	Buyout	490	65

40 See footnote 15.
41 See footnote 2.
42 See footnote 15.

Piramal Pharma	Carlyle	Pharmaceuticals	Growth Capital	450	20
Everise Holding (C3)	Brookfield	Technology	Buyout	400	>50
ECL Finance Limited	Farallon Capital and SSG Capital	Financial Services	Credit Investment	346	NA
Piramal Enterprises Limited	Farallon Capital	Financial Services	Credit Investment	300	NA

In addition, other notable infrastructure and real estate investment in 2020 (excluding RMZ Corp –Brookfield deal) as per the EY report were:[43]

Company	Investor	Sector	Stage	Deal value (US$ millions)	Stake (%)
Prestige Estates Projects Limited (rental income assets)	Blackstone	Real Estate	Buyout	1,500	100
ESR Cayman JV (industrial and logistics assets)	GIC	Real Estate	Buyout	600	80
Chennai Nashri Tunnelway Limited	Cube Highways	Infrastructure	Buyout	527	>50
RattanIndia Power Limited	Goldman Sachs, Varde Partners	Infrastructure	Credit Investment	566	NA
Ayana Renewable Power Private Limited	CDC Group, Green Growth Equity Fund, NIIF	Infrastructure	Buyout	390	NA
IndInfravit Trust	CPPIB, OMERS Infrastructure Management and others	Infrastructure	Growth Capital	246	24
Shapoorji Pallonji Infrastructure (5 solar assets)	KKR	Infrastructure	Buyout	204	100
Navayuga Roads Projects Private Limited (two road assets)	Edelweiss Alternative Asset Advisor	Infrastructure	Growth Capital	150	NA
Renew Power Limited	Development Finance Corporation	Infrastructure	Credit Investment	142	NA
Acme Cleantech (600 MW solar assets)	Actis	Infrastructure	Buyout	127	100

Distressed-asset space – the Insolvency and Bankruptcy Code 2016

The Insolvency and Bankruptcy Code 2016 (the Insolvency Code) proved to be not only a major factor in improving India's ranking by the World Bank for ease of doing business, but also one of India's most important economic and corporate regulatory reforms. The immediate impact of the Insolvency Code is evident from the improvement in India's ranking in World Bank's 'resolving insolvency index', moving up to 52nd position in 2020 from 108th position in 2019.[44] The Insolvency Code came at a time when the asset bubble had all but burst and the Indian banking system was collapsing on account of unprecedented amounts of non-performing assets (NPAs). The Insolvency Code gave teeth to the efforts to reform the banking and financial sector. Stressed assets have spiked the interest of global and domestic players, and the opportunity to strategically capitalise on a supply of NPAs across a number of core sectors at steep discounts has created fierce competition and a dealmaking frenzy in the distressed assets sector.

43 See footnote 15.

44 www.businesstoday.in/current/corporate/how-path-breaking-verdicts-crucial-amendments-shaped-insolvency-laws-in-2019/story/392738.html.

The distressed assets market was already going through teething problems when the covid-19 pandemic struck. Until February 2020, India witnessed 3,600 admitted cases relating to insolvency resolution out of which 205 were resolved and 89 have ended with liquidation. However, the number of admitted cases sharply dropped in 2020 as the government has suspended the insolvency proceedings against defaulting companies (i.e., companies who are unable to meet their payment obligations towards their creditors). This moratorium was put in place on account of the global pandemic and will be in continuation until March 2021.[45]

In 2020, as mentioned earlier, the most important amendments came through an ordinance to provide relief to pandemic-stressed companies by incorporating new provisions in the Insolvency and Bankruptcy Code 2016 (the Insolvency Code or IBC) that disallowed filing of applications for initiation of corporate insolvency resolution process. In addition, the appellate form, the National Company Law Appellate Tribunal has issued *suo moto* orders granting exclusion of lockdown period from the period of completion of corporate insolvency resolution process. Further, pursuant to a notification issued by the Ministry of Corporate Affairs (MCA) in March 2020, the threshold for minimum amount of default was increased from 100,000 rupees (approximately US$1,371.45) to 10 million rupees (approximately US$0.137 million).

India's macroeconomic troubles are attracting a new wave of global investors betting they can eke out profits from the rising number of capital-starved businesses struggling to stay afloat. Researcher Venture Intelligence calculates that funds have already pumped $1.5 billion in distressed assets in India this year, 55 per cent more than through all of 2019.[46]

Indian banks had the world's worst bad loan ratio among major economies even before its strict lockdown began in March, throttling economic activity. The central bank now estimates soured assets will rise to an over two-decade high of 12.5 per cent by the end of March 2021, from 8.5 per cent a year ago, a sign of the difficulties businesses will face.[47] With banks stepping up their efforts to clean out their balance sheets of NPAs and bad loans, providing unprecedented supply to asset reconstruction companies (ARCs), PE funds and SWFs are tying up with ARCs and setting up distressed funds to establish their footprint in the distressed space. After the government allowed foreign institutions to have 100 per cent ownership in ARCs, the RBI further sweetened the deal for PE participants by permitting listing of security receipts in December 2017.

Major global PE funds have either already set up or announced private credit platforms in India. Blackstone has acquired a controlling stake in distressed-asset buyer International Asset Reconstruction Company Private Limited, investing about US$150 million. KKR has been one of the early movers to tap private credit opportunities in India, acquiring a licence to operate an asset reconstruction company in India in December 2017. Among domestic private credit funds, the Edelweiss group has tied up with CDPQ, and Piramal Enterprises has teamed up with Bain Capital Credit to form India Resurgence Fund, to acquire distressed

45 www.businesstoday.in/current/economy-politics/insolvency-and-bankruptcy-code-suspension-to-remain-in-force-till-march-31-2021/story/425605.html.

46 www.livemint.com/companies/news/oaktree-apollo-lead-giants-betting-on-stressed-india-assets-11605674164704.html.

47 https://theprint.in/economy/global-funds-are-swooping-in-to-invest-in-indias-stressed-companies/546561/.

assets. In November 2020, India's largest private-sector mortgage lender HDFC Ltd acquired nearly 20 per cent. According to experts, the size of the market in opportunities in the NPA space is pegged at US$150 billion.[48]

With debt-laden groups being forced to sell their prized assets to deleverage their books and to avoid being dragged to insolvency courts by their creditors, Blackstone Group Inc, Warburg Pincus and several other PE firms in India took advantage of the situation and snapped up some attractive assets. While Blackstone acquired assets such as Aadhar Housing, Essel Propack and Coffee Day technology office park, Warburg Pincus acquired an 80 per cent stake in the education loan arm of financial services group Wadhawan Global Capital Ltd. In one of the major deals in distressed space, India's central bank asked Singapore-based DBS Group Holdings Ltd's India unit to take over capital-starved Lakshmi Vilas Bank Ltd in 2020.[49] While, marquee deals like Reliance Jio's proposed acquisition of debt-laden Reliance Infratel Limited (financial creditors are expected to take a haircut of as much as 90 per cent on their loans under the resolution plan) and Vedanta's Group proposed acquisition of 13 companies of insolvent appliance maker Videocon Industries were initiated in 2020, the biggest stressed asset transaction for 2020 in stressed asset was State Bank of India infusing 60.5 billion rupees in Yes Bank for a 48.2 per cent stake.

ii Financing

Any form of acquisition financing is limited to offshore sources, which can be problematic given restrictions on the creation of security on Indian assets in favour of non-resident lenders. Indian exchange control regulations prohibit Indian parties from pledging their shares in favour of overseas lenders if end use of the borrowing is for any investment purposes directly or indirectly in India. Indian companies that are foreign owned or controlled are prohibited from raising any debt from the Indian market to make any further downstream investments. In addition, Indian entities are not permitted to raise external commercial borrowings for the purposes of acquisition of shares. In addition, the Companies Act restricts public companies (including those deemed public companies) from providing any direct or indirect security or financial assistance for the acquisition of their own securities.

The less stringently regulated privately placed NCDs (which are outside the purview of the external commercial borrowing regime), which can be secured by Indian assets, have emerged as a form of debt financing for foreign PE investors. NCDs issued to FPIs are no longer mandatorily required to be listed. Indian masala bonds, which may be issued to overseas lenders, have emerged as another option for debt financing. However, PE investors are reluctant to use masala bonds to finance domestic acquisitions, as there is a prevailing view that proceeds raised through the issuance of masala bonds cannot be used for capital markets and domestic equity investments.

Given that acquisition financing is virtually non-existent in India, PE investors for Indian transactions traditionally deploy their own funds or funds leveraged offshore, which are subsequently brought as equity into India. In auction processes and large transactions, it is common for the seller to request equity commitment letters or financing arrangements to demonstrate the purchaser's ability to perform its obligations.

48 www.vccircle.com/partnership-model-drives-distressed-assets-opportunity-panellists-at-vccircle-event.

49 www.livemint.com/companies/news/oaktree-apollo-lead-giants-betting-on-stressed-india-assets-11605674164704.html.

iii Key terms of control transactions

Control deals and a paradigm shift in India

Investors are showing greater appetite for control deals in India. According to PwC, buyout deals have witnessed an increase in value of nearly 25 per cent compared to 2017. However, it was more on account of the cautious approach by the investors as a result of the pandemic in 2020. From 2015 onwards there have been several notable control transactions completed by PE investors, showcasing a shift towards acquiring a majority stake in target companies. Over the years, PE investors have garnered considerable insight about the challenges of working with Indian promoters, which include information asymmetry, insufficient middle management talent, limited exposure to best practices, and inadequate reporting and governance structures.[50] Investors are the key driving factors behind this paradigm shift:

a they want to achieve better corporate governance;

b there has been a significant increase in the expertise and in capability of PE investors to add value to their portfolio companies operationally;

c they want better operational control;

d they want to generate better returns on their investments;

e they want more control over exit opportunities and processes;

f there has been an increase in platform deals;

g there are larger amounts of capital available to invest; and

h there has been an increase in the number of co-investors with whom to share risk.

Control deals in India are based on two models: (1) the PE investor will either hire a fresh management team with a buyout of a majority stake or the whole company from the existing shareholders; or (2) the PE investor will acquire a majority stake or the whole company, with the pre-existing management team staying on.

According to a report by Alvarez & Marsal, in a typical control deal, PE firms utilise the following structure with interventions in the deal cycle in India:

a pre-deal: in-depth pre-deal due diligence checks of a target, with a focus on ensuring the presence of a good management team and identification of revenue enhancement opportunities;

b early holding period (the initial six to 12 months): setting the direction by acquisition of 'senior talent' and 'aligning objectives with management' and launching value creation initiatives;

c middle holding period: performance, execution, monitoring of value creation initiatives and selective intervention on key issues; and

d pre-exit: preparing for a successful exit by ensuring alignment with the promoter and company management.[51]

As an emerging trend, PE firms use the following models for value creation: (1) using a dedicated operating team; (2) hiring industry or functional experts who are proven leaders in the relevant sector with the ability to accelerate value creation; or (3) engaging external consultants.

50 www.alvarezandmarsal.com/sites/default/files/am_peops_operatingparadigmshift.pdf.

51 ibid.

Key terms and conditions

Key terms in recent control transaction in India include: (1) robust pre-deal due diligence to identify any legal, operational or financial issue; (2) robust business warranties backed by an indemnity from an entity of substance (which can include parent guarantees); (3) use of an escrow mechanism and deferred consideration for post-closing valuation adjustments and indemnities; (4) provision of management upside-sharing incentives to retain and incentivise management; and (5) use of a locked-box mechanism to protect value.

Challenges

Control transactions suffer from their own challenges in India, including the following:

a restrictions on account of regulations relating to tender offers in listed company acquisitions, and exchange control regulations relating to FDI in sectors having investment caps. Under Indian exchange control regulations, FDI in certain regulated sectors is not permitted beyond a specified limit;

b limited availability of acquisition finance in India;

c provisions involving a non-resident with respect to earn-outs, deposits and escrows must comply with the criteria set out by the RBI. In India, in the case of a transfer of shares between a resident buyer and a non-resident seller, or vice versa, up to 25 per cent of the total consideration can be paid by the buyer on a deferred basis from the date of the agreement or 25 per cent of the total consideration can be furnished as an indemnity for a period not exceeding 18 months from the date of payment of the full consideration;

d in exits by way of a secondary sale, the acquirer is likely to seek business warranties and indemnities (backed by an entity of substance) from existing PE investors; and

e in exits by way of an initial public offering (IPO) on the Indian stock exchanges, the controlling PE investor is likely to be classified as a promoter under applicable securities regulations and may be subject to lock-in and other restrictions.

Control deals in 2020

Compared to 2019, 2020 saw a sharp decline in buyout deals. 2020 recorded 43 buyouts worth US$11.8 billion compared to 61 buyouts worth US$16.5 billion in 2019. Overall buyout activity recorded a decline of 28 per cent in terms of deal value and 30 per cent in term of volume.[52] As per the PwC report, the risk averse approach adopted by several funds earlier in the year, as well as need for smaller rounds for cash infusion in cash strapped business, led to a drop in buyout activity in 2020.[53] In spite of a notable downward trend because of this cautious approach, 2020 saw its share of notable buyout deals.

One of the largest control deals was Brookfield's acquisition of controlling stake in real estate assets of RMZ corporation for US$2 billion. Certain other buyouts included PIF and ADIA acquiring a controlling stake in Reliance Digital Fibre Infrastructure Trust for US$1.02 billion, Blackstone acquiring a 100 per cent in assets of Prestige Estate assets for US$1.5 billion; Blackstone a 100 per cent stake in Piramal Glass Private Limited for US$1 billion, Thoma Bravo LP acquiring Majesco Limited (US business) for

52 See footnote 15.

53 See footnote 2.

US$729 million, New Mountain Capital acquiring Natrol LLC (US unit of Aurobindo Pharma) for US$550 million and KKR acquiring a controlling stake in JB Chemicals and Pharmaceuticals Limited for US$496 million.[54]

However, steered by the need for value creation, preservation and enhancement, control will remain a key element for most investors in future.[55] This was demonstrated by the late pick-up in buyout deals in last month of 2020, which recorded nine buyouts worth US$4.7 billion (40 per cent of all buyouts by value in 2020).[56] 2020 also witnessed signing of one of the biggest buyout deals in the Indian market (i.e., proposed acquisition of retail, wholesale, logistics and warehouse business of Future Enterprises Limited by Reliance Retail ventures for US$3.3 billion), which is expected to be completed in 2021. Control has become and will remain a key element and deal driver in most transactions.

iv Exits

2018 marked an inflection point for the PE/VC industry in India, with exits at US$26 billion, which approached the value of investments, demonstrating that the industry is moving towards mature market standards.[57] Amidst market volatility, the downward trend seen in 2019 continued in 2020 and exits reached an all-time low in the last six years. In 2020, exits declined 46 per cent in terms of value (US$6 billion versus US$11.9 billion in 2019) and 4 per cent in terms of volume (151 deals in 2020 versus 157 deals in 2019).[58]

Open market sales accounted for the largest share of the exit value in 2020 at US$2.4 billion (67 deals), a 47 per cent decline compared to 2019. Public offerings provided exits worth US$1.2 billion across nine IPOs in 2020 compared to US$247 million across eight IPOs in 2019. Exits via strategic sales dropped 47 per cent to US$1 billion across 44 deals. Secondary sales recorded their lowest value in 4 years at US$913 million across 20 deals.[59]

According to VCCircle, the following were the top exit deals by PE firms that fully exited portfolio firms in 2020.[60]

Top PE/VC full exit					
Target company	**PE seller**	**Exit amount (rupees)***	**Investment amount (rupees)**	**Internal rate of return (%)**	**Mode**
AU Small Finance Bank	Warburg Pincus	40,300,000,000	2,550,000,000	65–68	Open Market
AU Small Finance Bank	IFC	19,600,000,000	960,000,000 – 970,000,000	58–60	IPO + Open Market
Indus Towers	Providence	18,850,000,000†	21,000,000,000†	Likely haircut	Secondary (M&A)
Metropolis Healthcare	Carlyle	15,458,200,000	7,730,000,000	17–18	IPO + Open Market

54 See footnotes 15 and 2.
55 See footnote 2.
56 See footnote 15.
57 www.livemint.com/Companies/bPJGrKBJNwcQlJcDpGChRK/PE-VCinvestments-and-exits-in-India-on-par-so-far-in-2018.html.
58 See footnote 15.
59 ibid.
60 www.vccircle.com/flashback-2020-pe-firms-clock-big-exits-but-indian-vc-gets-most-bang-for-the-buck.

Top PE/VC full exit					
Target company	**PE seller**	**Exit amount (rupees)***	**Investment amount (rupees)**	**Internal rate of return (%)**	**Mode**
Laurus Labs	Warburg Pincus	14,000,000,000	5,500,000,000	23–24	IPO + Open Market
AU Small Finance Bank	ChrysCapital	12,800,000,000 – 12,850,000,000	1,350,000,000 – 1,360,000,000	53–55	IPO + Open Market
Intas Pharmaceuticals	Capital International	9,960,000,000	6,900,000,000	15	Secondary
Happiest Minds	JP Morgan CMDB II	4,523,300,000	680,000,000 – 700,000,000	43–44	IPO
IndiaMart	Elevation Capital	2,050,000,000 – 2,100,000,000	600,000,000 – 700,000,000	123–130	Open Market
* Multiple tranches leading to full exit in 2020 † VCCirle Estimates					

In addition, according to VCCircle, the following were the top partial exit deals by PE firms in 2020.[61]

Top PE/VC partial exit			
Target company	**PE seller**	**Exit amount (rupees)***	**Investment year**
SBI Cards†	Carlyle	70,400,000,000	2018
Embassy Office Parks REIT	Blackstone	22,750,000,000	2017
EPL (formerly Essel Propack)	Blackstone	18,500,000,000	2019
Crompton Greaves Electrical	Advent, Temasek	16,310,000,000	2015
Coforge	Baring PE Asia	8,780,000,000	2019
CAMS†	Warburg Pincus	7,513,300,000	2018
Manappuram Finance	Baring PE Asia	7,210,000,000	2011
Tanla Platforms	Blackstone	5,869,500,000	2018
Aavas Financiers	Partners Group	3,610,000,000	2016
* VCCirle Estimates † Exits vis IPOs; other exits are via open market deals			

Valuation concerns and expectation mismatch between buyers and sellers resulted in a number of exit plans being shelved in 2020. Despite a dull first half, exits through IPOs picked up pace in the second half of 2020. November and December saw monthly exits move up to US$1 billion. Open market exits remain strong and secondary exits are expected to recover sharply in 2021. With exuberant capital markets in India, there is an expectation of a number of PE/VC portfolio-driven listings in the first half of 2021.

IV REGULATORY DEVELOPMENTS

i Relevant regulatory bodies

In the context of PE investments, the relevant regulatory bodies in India are as follows.

61 ibid.

a the RBI: the central bank and monetary policy authority of India. It is also the foreign exchange regulator and executive authority for FEMA, responsible for notifying regulations on various aspects of foreign exchange and investment transactions from time to time;

b SEBI: India's capital markets regulator, which regulates all stock market activity. SEBI regulations are applicable when PE firms deal with listed securities;

c CCI: the competition regulator, which is required to pre-approve all PE transactions that fall above the thresholds prescribed in the Competition Act; and

d other sectoral regulators: depending on the sector where the PE investor makes an investment, there may be sectoral regulators who will also oversee the investment; for example, the MCA oversees corporate affairs, the RBI oversees banks and financial services companies, the Insurance Regulatory Development Authority oversees the insurance sector, the Telecom Regulatory Authority of India oversees the telecommunications sector and the Directorate General of Civil Aviation oversees the aviation sector.

ii Key regulatory developments

Amendments to foreign direct investment policy

Under the foreign direct investment policy (FDI Policy), any investment by a citizen or an entity of or incorporated in Bangladesh or Pakistan required prior government approval. Additionally, investments from Pakistan were prohibited in sectors such as defence, space and atomic energy. In this regard, a significant amendment to India's FDI policy came in April 2020 through Press Note 3 of 2020 (Press Note 3) issued by the Department of Industrial Policy and Promotion, Government of India, which imposed certain restrictions on investment in India by entities residing in countries sharing a land-border with India. Press Note 3 was issued with the intent of curbing opportunistic takeovers/acquisitions of Indian companies at distressed valuations, in light of the disruptions caused by the covid-19 pandemic. Pursuant to Press Note 3, any investment by an entity of a country that shares a land border with India or where the beneficial owner of an investment into India is situated in or is a citizen of any such country will require the prior written approval of the government of India. Accordingly, any potential investor into India will need to test their shareholding structure to confirm whether there is any beneficial ownership by an entity or individual with citizenship to whom such location restrictions apply.

In addition, Press Note 3 does not define the term 'beneficial ownership'. Accordingly, stakeholders have relied on the definition of beneficial ownership as defined in other legislations such as Companies (Significant Beneficial Owners) Rules, 2018 or the Prevention of Money-Laundering (Maintenance of Records) Rules, 2005. However, these legislations prescribe different thresholds for determination of beneficial owners, adding to the regulatory uncertainty.[62] In addition, Press Note 3 has introduced the requirement of prior approval of the government of India in case of transfer of any current or future foreign direct investment in any Indian entity that results in the beneficial ownership being transferred to any person of a country sharing its land borders with India.

62 The Companies (Significant Beneficial Owners) Rules, 2018 prescribe a threshold of 10 per cent for significant beneficial owner of a company while the Prevention of Money-Laundering (Maintenance of Records) Rules, 2005 prescribe 25 per cent controlling ownership or profit share of the company or person who holds the position of senior managing official, for identifying the beneficial owner.

Another important amendment to the FDI policy was introduced in February 2020 pursuant to which foreign investors are now permitted to acquire up to a 100 per cent stake in an insurance intermediary, subject to verification by the Insurance Regulatory and Development Authority of India. Accordingly, investments in intermediaries such as insurance brokers, insurance consultants, surveyors and third-party administrators can be made under the automatic route.

Relaxations under the IBC

As set out in Section III, the government has provided certain exemptions and relaxations through certain amendments to the IBC, one of the most significant being the prohibition on filing of applications for corporate insolvency resolution (against entities that have defaulted in payments to their creditors), after 25 March 2020. This relaxation was initially valid for a period of six months but has now been extended until 31 March 2021. In addition, the resolution professional (appointed for, inter alia, overseeing the insolvency resolution process) has been precluded from initiating proceedings against directors of corporate debtors accused of fraudulent or wrongful trading, for instances where the filing of applications for initiation of the corporate insolvency resolution process have been disallowed. Another notable development is the increase in the minimum amount of default from 100,000 rupees (approximately US$1,371.45) to 10 million rupees (approximately US$0.137 million). Consequently, the number of admitted cases have reduced significantly, which has provided much need relief to companies dealing with the onslaught of the covid-19 pandemic.

REITs and InvITs

In January 2020, SEBI issued guidelines on rights issue of units by InvITs and REITs which were subsequently amended in March 2020. These guidelines provide a framework for issue of units by a listed InvIT or REIT to its unitholders, prescribing certain conditions such as a minimum subscription of 90 per cent, pricing and provision for fast-track rights issue. This will ensure that the REITs are able to raise funds while at the same time meeting certain regulatory thresholds.

In June 2020, SEBI amended the REIT Regulations and the Infrastructure Regulation with a view towards enhancing the ease of doing business in India. One of the key amendments permitted sponsors of InvITs and REITs, whose units have been listed for a period of three years to de-classify themselves (i.e., cease to be a sponsor), subject to the approval of the unitholders of the relevant InvITs and REITs. This amendment will effectively allow the persons identified as sponsors to step down from such position subject to the fulfilment of certain conditions.

Another key change relates to change of, or change of control of, the sponsor or the inducted sponsor of an InvIT or REIT, which now requires approval of 75 per cent of the unitholders of the relevant REIT/InvIT (by value) excluding the value of units held by parties related to the transaction. In the event such approval is not obtained, the inducted sponsor or sponsor needs to provide an exit to the dissenting unitholders by purchasing their units. In addition, the term 'change in sponsor' has been defined to mean any change as a result of the entry of a new sponsor, whether or not the existing sponsor has exited. This amendment effectively grants additional protections in relation to the rights of unitholders of just investment trusts.

In this context, it is noteworthy to mention that prior to June 2020, each sponsor under the REIT Regulations needed to hold at least 5 per cent of the outstanding units of a REIT at any time. In addition, the sponsor and its sponsor group were required to hold at least 15 per cent of the outstanding units of the REIT. The amendments to the REIT Regulations in 2020 have done away with the perpetual lock-in of sponsor and sponsor-group's unitholding. Currently, the REIT Regulations mandate a post-listing lock-in of 25 per cent of the outstanding capital of REIT for a period of three years. Moreover, a lock-in period of one year will apply in the event the unitholding exceeds 25 per cent in the REIT.

Amendments to AIF Regulations

In October 2020, SEBI amended the requirements to be fulfilled by the key investment team of the 'manager' of an AIF. Under the new norms, the key investment team of the manager of an AIF should have a minimum of five years' experience and adequate professional qualifications. These requirements may be fulfilled individually or collectively by the personnel of the key investment team.

In addition, a new provision was added to the AIF Regulations which provides that the manager of the AIF will be responsible for all the investment decisions of the AIF. In this context, the manager may constitute an investment committee subject to compliance with certain conditions, including the following: (1) members of the committee will be equally responsible for the investment decisions as the manager; (2) the manager and the investment committee will jointly and severally ensure compliance of the investments with the AIF Regulations, any fund documents or any agreement with the investors; and (3) external members whose names were not disclosed in the placement memorandum may be appointed only with the consent of 75 per cent of the investors (by value of their investment in the AIF). Such provisions have been introduced for ensuring the competency of the key investment teams of AIF managers.

Amendments in the consequences of certain offences under the Companies Act, 2013

To ensure ease of compliance, the MCA has modified the consequences of certain offences under the Companies Act, 2013 (CA 2013) and deleted the penal provisions for other offences. The recent amendments introduced in September 2020, inter alia, provided for a reduction in the amount of monetary penalty for certain offences (such as failure to filing notices for alteration of share capital, filing of annual return, filing of board or shareholders' resolutions and surpassing the prescribed maximum number of directorships).

In addition, the several existing offences have been de-criminalised by removing the penalty of imprisonment in relation to, inter alia, offences pertaining to buy-back of securities, mis-statements in financial statements and board's report, improper constitution of sub-committees and failure of directors to disclose interest in matters in which they are interested. Moreover, the amendments also re-categorised certain offences from compoundable offences to in-house adjudication framework. Accordingly, various registrars of companies can now adjudicate on such offences, thus reducing the burden of the National Company Law Tribunal.

In addition to the aforesaid changes introduced for the purpose of easing the compliance requirements of companies doing business in India, CA 2013 has been appropriately amended to deal with the exigencies of the covid-19 pandemic. Earlier, certain matters (such as approval of annual financial statements, board report and prospectus) could not be dealt with in a board meeting through video conferencing or any other audio-visual means. In other words, decisions on such matters required the physical presence of the requisite quorum of directors. This condition has been relaxed in March 2020 and will continue until June 2021. Accordingly, all corporate matters can now be dealt with in a board meeting through video conferencing or any other audio-visual means, without any restriction. In respect of general meetings of shareholders of a company, the MCA has issued several circulars and directions in 2020 that have set down the norms to be followed for conducting such meetings through video conferencing or other audio-visual means until 31 December 2021.

Filing of resolutions by NBFCs

Under CA 2013, banking companies were exempted from filing of resolutions passed by their board of directors for grant of loans, guarantees or providing security in respect of loans, in the ordinary course of their business. Pursuant to the amendments to CA 2013 in September 2020, such exemption has now been extended to all classes of non-banking financial companies and housing finance companies. This exemption will reduce the day-to-day procedural burden on the non-banking financial companies and housing finance companies that perform activities similar to those of banking companies.

Relaxations for conducting board and general meetings of companies

As per the Companies (Meetings of Board and its Powers) Rules, 2014, certain matters (such as approval of annual financial statements, board report, prospectus, etc.) cannot be dealt with in a board meeting through video conferencing or any other audio-visual means, except where the quorum requirement is satisfied by the directors physically present. This condition has been relaxed through amendment to the relevant rule in March 2020, in light of the restrictions posed by the global pandemic, and shall continue until June 2021. Accordingly, all matters can now be dealt with in a board meeting through video conferencing or any other audio-visual means without any restriction.

In respect of general meetings, the MCA has issued several circulars and directions in 2020 to ease certain norms: (1) extension of due date for conducting annual general meeting until 31 December 2020; and (2) permitting conducting of extra-ordinary general meetings as well as annual general meetings through video conferencing or other audio-visual means until 31 December 2021, subject to compliance of the procedural requirements specified in the relevant circulars.

Developments relating to compromise or arrangement

In February 2020, the central government notified Sections 230(11) and 230(12) of the CA, which deal with takeover offers in unlisted companies. The sections provide for arrangements between a company and its creditors or members or any class of them, specifying the procedure to be followed to make such a compromise or arrangement.

The newly notified Section 230(11) provides that in the case of unlisted companies, any compromise or arrangement may include a takeover offer. Section 230(12) permits a party aggrieved by the takeover offer to make an application, bringing its grievance before the National Company Law Tribunal (NCLT). In addition, the MCA has also notified the corresponding rules that prescribe the manner in which applications may be made under the aforesaid sections.

In effect, these provisions allow majority shareholders, holding 75 per cent of the shares of a company, to make a takeover offer to acquire any part of the remaining shares, by way of an application before the NCLT. For this purpose, shares have been defined to mean equity shares or securities such as depository receipts, which entitle the holder thereof to exercise voting rights. In addition, the amended rules set out the manner in which a minority shareholder (or any other party) aggrieved by such offer may make an application to the NCLT in relation to his or her grievances.

V OUTLOOK

It would appear that 2020 was a blockbuster year for PE dealmaking in India. Legal and policy reforms towards ease of doing business in India reinforced the belief in India of PE/VC investors, SWFs and deep-pocketed strategic investors. However, 2021 will test the maturity, adaptability and resilience of Indian markets, and the following factors will have a major impact on investing in India throughout the coming year.

a Global environment, covid-19 and vaccine: uncertainty and volatility triggered by major geo-political events (United States–China ties, India–China ties, the impact of the coronavirus and any new lockdowns), a strong dollar against other currencies and the imposition of new sanctions and trade barriers by nations may keep impacting upon emerging markets in general.

b Investor outlook: fundamentals for investment in India will remain strong in the long run, with key drivers such as (1) major reforms aimed at cleaning up the economy and improving ease of doing business in India; (2) record levels of dry powder at the disposal of Asia-focused private equity funds; (3) the race for dominance in the telecom, technology, e-commerce industry; (4) renewed interest in India's growth story from very deep-pocketed long-term institutional investors, SWFs and strategic buyers; and (5) the availability of high-quality distressed assets on the auction block.

c Primary triggers: triggers include (1) consolidation to strengthen market position; (2) financial deleveraging; (3) monetising of non-core assets; (4) entering new geographies; (5) the faster pace of insolvency proceedings; (6) the great Indian distressed-asset sale supplying assets at attractive valuations across a number of core areas; (7) the increased appetite of investors, SWFs and strategic buyers for control deals, co-investment deals and platform deals are all expected to keep driving dealmaking activity in India in 2021. Pharmaceuticals, insurance, telecom, technology, e-commerce, real estate, infrastructure, stressed assets, healthcare, financial services, energy and manufacturing are sectors that are expected to continue receiving interest from investors in 2021.

d The government of India has put in motion plans to divest a number of central public sector enterprises. This will provide an unparalleled opportunity to strategic buyers and consortiums of PE funds and SWFs to snap up some of the crown jewels of the Indian public sector. Not only will divestments provide access to the untapped potential of public sector enterprises but they will also lead to mega billion-dollar deals because of the size and valuation of these heavyweight assets.

As we progress into 2021 with the worst of the global pandemic behind us, India is likely to be one of the fastest growing major economies over the next decade, which makes it an extremely attractive market for the global private equity industry. PE investments are expected to grow by 15 to 25 per cent as a result of India's growth potential owing to government initiatives and enhancements in ease of doing business, as well as an above average showing in results by the Indian industry over 2020. Overall, the deal triggers seen in 2020 are expected to continue to drive both deal values and volumes in 2021.

Chapter 7

JAPAN

Shuhei Uchida[1]

I OVERVIEW

i Deal activity

The Japanese private equity market continues to be quite active, taking advantage of the stability of the economy since 2013 despite the covid-19 pandemic. Also, as a result of monetary easing and the negative interest rate policy adopted by the Bank of Japan, it has become easier for private equity firms to raise acquisition financing from Japanese banks. According to the RECOF M&A database, 100 acquisition transactions by investment firms (most of which are private equity funds) were announced during 2020, with a significant increase from 81 deals in 2019. Among them, five deals were contemplated as public-to-private transactions.

There has been a growing number of small and medium-sized transactions involving succession of family-owned companies. Additionally, as a result of the continuous review of business portfolios as recommended under Japan's Corporate Governance Code, an increasing number of listed companies have been implementing divestitures of subsidiaries and non-core businesses.

According to the RECOF M&A database, there had been around 50 exit transactions per annum by investment firms through trade sales or secondary buyouts in recent years. In 2020, 37 deals were announced, with a slight decrease from 49 deals in 2019.

There are several types of private equity funds that are active in Japan. Many of the mega-deals are conducted by global funds such as KKR, Bain Capital, Carlyle and Blackstone. There are also independent domestic funds, such as Unison Capital, Advantage Partners and Integral, as well as funds managed by financial institutions such as banks and securities companies.

Further, government-related funds have recently been playing an increasingly important role in the private equity market. A remarkable example is the Japan Investment Corporation (JIC), which is a public–private fund sponsored by both the Japanese government (injecting ¥286 billion) and 25 private corporations (¥13.5 billion in total). Although JIC has been inactive following the resignation of all directors from the private sector as a result of a dispute with the government over their compensation, it is reported that it will restart investment activities under new management established in December 2019.

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ii Operation of the market

Management incentive arrangements

Typical management incentive arrangements adopted in private equity deals in Japan include performance-based annual bonuses and stock options. In addition, top management can hold minority shares in the company. Private equity funds commonly enter into agreements (e.g., executive services agreement) with management to set out predetermined performance targets for annual bonuses to incentivise the management. Stock options are occasionally subject to performance vesting features. Stock options often become exercisable upon exit of the private equity fund.

Sales process

The most common forms of exit by private equity funds are trade sales, secondary buyouts and initial public offerings (IPOs). Particularly, a trade sale of shares to a strategic buyer that conducts a business similar to that of the target company is the most common exit form, with its simple and straightforward nature enabling the private equity fund to obtain an immediate return on the entire investment (although there may remain indemnity obligations or a balance of payment held in escrow). To induce the most favourable terms for the sale, private equity funds as sellers tend to conduct an auction process before starting negotiations with the selected buyer on an exclusive basis.

There has recently been an increase in secondary buyouts. The secondary buyout is an attractive option where, for example, the initial buyout fund's investment period is close to expiry but the IPO of the portfolio company is expected to run for longer.

Also, since the revival of the Japanese IPO market, a growing number of private equity funds have been trying to exit through IPOs, which was once uncommon in the Japanese private equity market. While the possibility of an IPO largely depends on the market environment, and the preparation for an IPO usually requires much time, resources and cost, an IPO could be an attractive option in that it could realise greater value without imposing heavy post-closing liabilities on the seller.

II LEGAL FRAMEWORK

i Acquisition of control and minority interests

Buyouts of private companies

In the case of buyouts of private companies, the most common legal framework is a simple sale and purchase of shares in the target company. A stock purchase agreement entered into between the seller and the buyer is the principal document providing the terms and conditions of the transaction.

Buyouts of listed companies

Buyouts of listed companies (i.e., public-to-private transactions) are typically conducted through a two-step acquisition involving a first-step tender offer and a back-end squeeze-out of the remaining minority shareholders.

An acquisition of shares in the first-step transaction needs to be conducted pursuant to the tender offer regulations under the Financial Instruments and Exchange Act (FIEA), which require a tender offer for a transfer of listed shares resulting in the acquirer holding more than one-third of the voting rights of the listed company. The principal documents for buyouts of public companies are the tender offer documents such as the tender offer registration statement filed by the offeror (buyer) and the position statement filed by the target company. Terms and conditions of the tender offer are provided in the tender offer registration statement to be prepared in accordance with the FIEA and relevant regulations. Also, in cases where the target company has a major shareholder, a tender offer agreement may be entered into between the offeror and the major shareholder, which provides the offeror's obligation to commence the tender offer and the major shareholder's obligation to tender in the tender offer. The offeror and the target company are not prohibited from agreeing upon deal protection measures such as a no-shop clause and breakup fees, but tend to avoid doing so to ensure fairness of the transaction process.

For the back-end squeeze-out, two practical alternatives have been commonly used: (1) a squeeze-out right that is available to a special controlling shareholder, and (2) a fractional share squeeze-out through, among other things, a stock consolidation. The squeeze-out right, which was introduced with the 2016 amendment of the Companies Act, enables a shareholder holding (directly or through one or more wholly owned subsidiaries) at least 90 per cent of the total voting rights (special controlling shareholder) to force a cash acquisition of the remaining shares held by the minority shareholders. The effect of the squeeze-out right is simple and straightforward; the relevant shares are transferred directly from the minority shareholders to the special controlling shareholder. This alternative only requires a resolution of the board of directors of the target company instead of a shareholder resolution (which typically takes a couple of months), and, therefore, significantly expedites the squeeze-out procedure in comparison with the other alternatives. In practical terms, it is possible to complete the back-end squeeze-out as early as one month after completion of the first-step tender offer. Because of the simple and expedited procedure, since its introduction under the amended Companies Act, the squeeze-out right has been most commonly used for back-end squeeze-outs where the acquirer satisfies the 90 per cent voting rights requirement. Another alternative available for the back-end squeeze-out is a fractional share squeeze-out, which is typically conducted through a share consolidation. In this type of squeeze-out, the target company, pursuant to a shareholder resolution, consolidates its shares by a ratio that would result in minority shareholders holding only fractional shares. In accordance with a procedure provided under the Companies Act, these fractional shares are not actually issued but sold to the acquirer upon court approval, with the cash proceeds distributed proportionately to the minority shareholders. A fractional share squeeze-out does not require the acquiror to hold 90 per cent of the voting rights of the target. Therefore, if the acquirer fails to reach the 90 per cent threshold on completion of the first-step tender offer, making the squeeze-out right unavailable, a fractional share squeeze-out would still be available as long as it is approved by a shareholder resolution with a supermajority vote (two-thirds of the votes cast).

In contrast, cash mergers have not been commonly used for back-end squeeze-outs because, unlike the common alternatives above, a cash merger was treated as a taxable transaction at the level of the target company. However, this difference in tax treatment was eliminated after the amendment to the Corporation Tax Act in 2017. Given that cash mergers are available through a shareholder resolution of the target company with a supermajority vote even if the 90 per cent voting rights requirement is not satisfied, they may be used more commonly in the future.

Antitrust filing requirements

Under the Act on Prohibition of Private Monopolisation and Maintenance of Fair Trade (the Antimonopoly Act), a pre-transaction filing is required for an acquisition of more than 20 or 50 per cent of the voting rights of the target company if the aggregate amount of the domestic sales of the buyer group exceeds ¥20 billion or the aggregate amount of the domestic sales of the target company group exceeds ¥5 billion, respectively. In the case of an acquisition by a private equity fund, the domestic sales of the fund's portfolio companies may be included in the sales of the buyer group, depending on the fund structure. If the pre-transaction filing is necessary, a 30-day waiting period (which may be shortened if the transaction does not raise substantive antitrust issues) is applicable and could affect the closing schedule.

Foreign investment filing requirements

The Foreign Exchange and Foreign Trade Act (FEFTA) obliges a foreign investor contemplating a certain foreign direct investment (FDI) to make a pre-transaction notification if the FDI targets certain restricted businesses. FDIs subject to the pre-transaction notification requirements are reviewed by the Ministry of Finance and other relevant ministries and subject to a statutory waiting period of 30 days. The waiting period can be extended to up to five months, but would usually be shortened to two weeks or less as long as the FDI does not raise any regulatory concern.

Recently, there have been a series of amendments to the pre-transaction notification requirements under the FEFTA. Most importantly, an amendment that added 20 types of businesses (newly added businesses) to the list of restricted businesses became effective on 1 August 2019, and pre-transaction notifications are required for FDIs targeting newly added businesses consummated on or after 31 August 2019. The newly added businesses are divided into the following categories:

a manufacturing of information processing equipment and parts;
b software related to information processing; and
c information and communications services.

Among others, the software category is widely defined, and any business involving development of software that is not game software could be deemed to fall under this category. The authorities also tend to interpret the scope of internet use support services, which fall under the information and communications services category, widely, and any business providing internet services (including services that are not typically seen as support services) could be deemed to fall under this category. As such, the newly added businesses category may apply to a wide range of businesses, including start-up and technology companies. Additionally, it has been clarified that a general partnership, limited partnership for investment under the Limited Partnership Act for Investment of Japan, and other similar partnerships under foreign laws fall within the foreign investor category if 50 per cent or more of the contributions are made by non-residents, or a majority of the general partners are non-residents. Therefore, private equity funds satisfying these criteria are now required to make pre-transaction notifications in a much broader range of transactions than before.

ii Fiduciary duties and liabilities

Fiduciary duties

Under Japanese law, it is commonly understood that a controlling shareholder does not owe any fiduciary duty to the minority shareholders. On the other hand, company directors owe a fiduciary duty to the company, which could include a duty to take account of the shareholders' common interests. Particularly, as the Tokyo High Court ruled on 17 April 2013, in the case of management buyouts by a two-step acquisition as described in Section II.i, directors of the target company owe the duty to ensure a fair transfer of corporate value among the shareholders and the duty to disclose adequate information.

In addition, a highly remarkable ruling by the Supreme Court on 1 July 2016, involving a public-to-private transaction conducted by certain major shareholders of the target company through a two-step acquisition, held that the squeeze-out price is generally considered fair if it equals the price offered in the first-step tender offer and is determined through a fair process.[2] While the Supreme Court ruling in the *Jupiter Telecom* decision directly relates to the fairness of the squeeze-out price to be examined in an appraisal procedure, it also has a significant impact on the discussion regarding the duties of directors of the target company under similar circumstances (i.e., conflict-of-interest transactions).

Contractual duties and liabilities

Upon its entry investment, a private equity fund as buyer may owe certain (though limited) post-closing duties, including continued employment of the target company employees, under the stock purchase agreement (in the case of buyouts of private companies) or the tender offer agreement (in the case of buyouts of listed companies).

In contrast, upon exit, a private equity fund as seller would owe broader contractual liabilities under these agreements, including liabilities for indemnification in relation to any breach of representations and warranties or covenants. Depending on the bargaining power of the seller under the specific circumstances, the seller typically strives to limit the scope of its representations, warranties and covenants and to otherwise add contractual mechanisms to limit its post-closing liabilities, such as a limitation on the amount of indemnification (e.g., cap, *de minimis*, deductible or tipping basket) and a limitation on the period for indemnification (e.g., survival period of representations and warranties).

III YEAR IN REVIEW

i Recent deal activity

On 28 June 2019, the Ministry of Economy, Trade and Industry (METI) formulated the Practical Guidelines for Group Governance Systems, which, among other things, pointed out the conflict-of-interest issues between the general shareholders of a listed subsidiary and its parent company. To address these issues, an increasing number of Japanese companies that have listed subsidiaries have been considering an acquisition of the remaining shares in the listed subsidiary (i.e., public-to-private transaction) or a sale of the listed subsidiary. In the latter case, private equity funds could be good candidates for buyers.

Also, the Fair M&A Guidelines formulated by METI on 28 June 2019 emphasised the need to take appropriate measures to ensure the fair process for conflict-of-interest transactions

2 *Jupiter Telecom* decision.

such as management buyouts and acquisitions of listed companies by controlling shareholders (including parent companies). These measures include market checks and the establishment of a special committee and majority-of-the-minority conditions. While the scope of direct application of the Fair M&A Guidelines is limited to the conflict-of-interest transactions described above, it is generally understood that reference to the Fair M&A Guidelines could contribute to ensuring the fairness of other types of M&A transactions, including the sale of listed subsidiaries by parent companies. In light of the Fair M&A Guidelines, there have been an increasing number of transactions involving private equity funds as buyers where special committees are established or active market checks are conducted through an auction process or an individual solicitation to multiple-buyer candidates.

The most significant deals in recent years include the acquisition of KIOXIA Holdings Corporation (formerly Toshiba Memory Corporation) by Bain Capital and other investors in 2017, and the acquisition of Marelli Corporation (formerly Calsonic Kansei Corporation) by KKR in 2017.

ii Financing

Typical leveraged buyouts by private equity funds are funded by the composition of debt and equity (typically in the form of common stock). The debt-to-equity ratio generally ranges from 2:1 to 1:1.

The debt financing package typically consists of a senior term loan facility and revolving facility for working capital purposes. Typically, one or more arranger banks underwrite these facilities upon the acquisition, and then syndicate these facilities within a general syndication period (which is usually six months to one year after the signing or first use). Some transactions also use mezzanine financing, which is usually structured as subordinated loans, subordinated bonds, subordinated convertible bonds or preferred shares. Equity kickers, typically in the form of stock options, are sometimes granted to mezzanine finance providers as an incentive. Interest payments under mezzanine financings often include, together with cash payment interest, payment-in-kind interest, which is usually accrued on a compounded basis that will become due on the maturity date, after full repayment of senior debt. High-yield debt is not commonly used.

In acquisition financing, the lenders usually request a long list of (1) conditions precedent for the drawdown, (2) representations and warranties that are repeated with each use, (3) covenants, including financial covenants and capex restrictions, and (4) events of default. Among other things, it is notable that the lenders usually require inclusion of an absence of material adverse change as a condition precedent for the drawdown. This means that a private equity fund as buyer usually needs to include the equivalent condition precedent for the completion of the acquisition under the stock purchase agreement (or, in the case of a tender offer, for the commencement of the tender offer).

iii Key terms of recent control transactions

Antitrust clearance

We have recently seen an increasing number of transactions in which antitrust clearance in one or more jurisdictions is required prior to the closing. Particularly, global-based private equity funds often need to obtain clearance from the antitrust authorities in multiple jurisdictions. In some cases, it takes a long time to close the transaction as a result of these antitrust requirements. In this regard, it is notable that, in the case of a tender offer, the competent governmental authority (Kanto Financial Bureau) usually requires the necessary antitrust clearance to be obtained prior to the commencement (as opposed to the settlement) of the tender offer. This could further delay the commencement of the tender offer and cause the whole deal process to take an even longer time.

In transactions requiring antitrust clearance, obtaining such clearance by the buyer is usually included as a condition precedent in the stock purchase agreement or the tender offer agreement. On the other hand, the seller would request contractual arrangements to ensure deal certainty. In this context, we have recently seen some transactions that have included a reverse breakup fee payable by the buyer if it fails to obtain necessary antitrust clearance. Additionally, especially in a competitive auction process, private equity funds sometimes accept a 'hell-or-high-water clause' to enhance their position as compared to strategic bidders from an antitrust perspective.

Conditionality

In buyouts of private companies, the stock purchase agreement typically provides customary conditions precedent, such as absence of breach of representations, warranties and covenants; necessary approvals of relevant authorities (including the antitrust clearance discussed above); and third-party consent. In addition, a private equity fund typically requests the closing to be conditioned on the absence of any material adverse change. Depending on the buyer's negotiating leverage, a finance-out condition is also provided in some cases.

For buyouts of listed companies, the terms and conditions of the tender offer need to be in accordance with the FIEA. Therefore, a narrower scope of contractual scope is allowed, and the contractual buyer protections available to private equity funds tend to be much more limited than those available for buyouts of private companies. In particular, because of the strict restrictions on withdrawal of a tender offer under the FIEA, it is difficult to effectively provide conditions precedent as broad as those typically provided in a stock purchase agreement for buyouts of private companies.

Representation and warranty insurance

In Japan, the use of representation and warranty insurance has not been common, partly as a result of the time involved and the cost of purchasing the insurance. While domestic insurance companies have recently begun to provide representation and warranty insurance, foreign insurance companies are still dominant in this area. Therefore, it is usually necessary to prepare the due diligence report in English as well as provide an English translation of the acquisition documentation. Communication in English is also required in the underwriting call.

However, as the advantage of representation and warranty insurance is beginning to be broadly recognised among practitioners, we may see more transactions in which representation and warranty insurance is used. In particular, it is generally recognised that representation and warranty insurance could be beneficial where a private equity fund as seller desires to limit post-closing liabilities or where a private equity fund as a buyer candidate in the auction process desires to make its proposal more attractive to the seller.

iv Exits

A total of 37 exit transactions by private equity funds through a trade sale or secondary buyout were announced during 2020.

IV REGULATORY DEVELOPMENTS

A control investment by a private equity fund may be subject to the pre-transaction filing or notification requirements under the Antimonopoly Act and the FEFTA. In particular, after the recent amendment to the FEFTA, a broader range of acquisitions by private equity funds are likely to be subject to the pre-transaction notification requirements (see Section II.i).

V OUTLOOK

Given the currently stable market environment in Japan, continued growth of the Japanese private equity market can be expected going forward.

One of the potential changes we may see in the M&A market relates to hostile deals. Until recently, hostile takeovers, including competing tender offers after the announcement of originally friendly tender offers, had been uncommon in Japan, and there had been few precedents of successful hostile takeovers of Japanese listed companies. However, we have recently seen more cases of successful hostile takeovers (e.g., Itochu Corporation's partial tender offer for Descente Ltd and acquisition of Ootoya Holdings Co, Ltd by Colowide Co, Ltd) and of originally friendly tender offers failing because of a competing tender offer with a higher price (e.g., the failure of HIS Co, Ltd's tender offer for an acquisition of Unizo Holdings Company, Limited). As the negative perception against hostile takeovers is decreasing, we may see more cases of successful hostile takeovers in the near future.

Chapter 8

LUXEMBOURG

Patrick Mischo, Frank Mausen, Jean-Christian Six and Peter Myners[1]

I OVERVIEW

i Deal activity

During the course of the past decade, Luxembourg has become one of the most important hubs for private equity capital raising and transaction activity in the world. Every year, Luxembourg investment platforms raise huge amounts of capital and deploy it across hundreds of private equity transactions within the European Union and beyond, and this year was no exception.

Luxembourg investment platforms come in different shapes and sizes, as do the managers that manage them, ranging from mega funds with multibillion-euro flagship funds established in Luxembourg managed by Luxembourg alternative investment fund managers (AIFMs) with many hundreds of Luxembourg holding companies, to more bespoke, stand-alone structures. Private equity managers with a substantial presence in Luxembourg include EQT, CVC, Apollo, Oaktree, Blackstone and Lone Star.

With so many private equity investments being held by Luxembourg holding companies, it is no surprise that a large and increasing number of M&A transactions involve target companies or target groups that are established in Luxembourg. It is fair to say that the majority of M&A activity involving Luxembourg companies concerns holding companies (i.e., Luxembourg companies that hold assets outside Luxembourg, rather than operational companies). However, private equity funds or their portfolio companies have acquired and continue to participate in sales processes involving Luxembourg-based businesses. A particularly hot sector over the past year or so has been the Luxembourg funds sector – fund managers, fund administrators, fund exchanges and the asset management arms of financial institutions – as investors look to gain exposure to the buoyant funds industry (e.g., TMF, backed by Doughty Hanson, acquiring Selectra, and Apex, backed by Genstar Capital, acquiring FundRock).

ii Operation of the market

A Luxembourg private equity structure will often involve co-investment, joint venture arrangements or management incentivisation. In these structures, rather than being wholly owned by the fund, equity or debt instruments are issued by the Luxembourg company to various stakeholders, and for the sponsor it will be essential to maintain control. It is possible under Luxembourg law for the sponsor to maintain that control, while at the same time accommodating the commercial interests of other stakeholders, provided that the appropriate

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types of company and instruments are used and the rights and obligations of each party are clearly set out in applicable contractual arrangements as well as the constitutional documents of the Luxembourg company.

A key structuring discussion will be in relation to the form of instruments to be issued. Luxembourg law provides for a wide range of possibilities: ordinary share capital, preferred equity, redeemable shares, tracking shares, founder shares, preferred equity certificates, fixed interest loans and bonds, variable interest loans and bonds, or (as is typically the case) some combination of these. A common reason for having a mix of instruments, rather than financing purely through equity, is to avoid a 'cash trap' situation in which there are insufficient distributable amounts to enable a dividend to be declared or shares to be redeemed.

The sharing of the proceeds of an investment – whether during the life of the investment or at exit – can be disproportionate to the amount of share capital or (in the case of debt) principal held by the relevant stakeholders. Management or other stakeholders can hold a *de minimis* stake in percentage terms, and, therefore (in the case of equity and debt instruments such as bonds that are subject to voting arrangements), a small proportion of voting power, while participating in substantial upside via a commercially agreed waterfall that is linked to internal rate of return performance. There are some Luxembourg law constraints (e.g., it is not possible to entirely exclude the risk of losses or the possibility of obtaining a return – the *clause léonine* rule), but in general, parties have contractual freedom to set out their agreed commercial terms.

Private equity sponsors who structure management incentivisation packages (MIPs) using Luxembourg companies will want to ensure that management cannot prevent them from exercising control and, for example, exiting when the time is right. Management would typically hold a small number of shares and undertake either not to vote or to vote as the sponsor directs. These voting waivers and undertakings must be carefully drafted, and they are often combined with default clauses, powers of attorney, call options or share pledges. Following the recent reform of the Luxembourg companies act, it is possible for a board to suspend the voting rights of a shareholder who breaches the company's constitution. It is also possible in certain types of Luxembourg companies to issue non-voting shares. Where this is not possible, founder shares are a common alternative. These do not form part of the share capital but may be voting or non-voting and may have such economic rights as the articles provide.

Ensuring that management exit when required to do so can be achieved in a number of ways: (1) drag-along provisions backed by call options or share pledges in favour of the sponsor or fund, or (2) by 'corralling' management into a separate MIP vehicle, such as a partnership limited by shares (SCA) or a limited partnership (SCS or SCSp), which then invests alongside the main fund. Such an MIP vehicle would typically be managed by the sponsor, so that any consents that are required in connection with an exit are certain to be given, with management holding limited partnership interests and, typically, having the benefit of certain limited veto rights designed to protect their economic interests. This means that if there are disputes with or among management members as to their respective entitlements, these disputes are isolated within the MIP vehicle and litigation will not threaten to derail the sales process.

II LEGAL FRAMEWORK

i Acquisition of control and minority interests

The Luxembourg 'toolbox' has expanded over the years and is now extensive and able to accommodate most structuring requirements. A typical private equity investment structure might include one or more SCS or special limited partnership (SCSp) funds to raise capital from investors at the top of the structure, and multiple master, intermediate or asset level holding companies (often Sàrls, but also, increasingly, SCSps because of the lower operating cost) below the fund. These holding companies are typically used to accommodate co-investors or joint venture partners, obtain senior, mezzanine or other forms of financing, issue bonds, incentivise management or simply block potential liability.

The Sàrl remains the most frequently used type of Luxembourg entity, but in terms of relative growth, the SCS and SCSp have become increasingly popular. The SCA is also another frequently used type of entity. Each of these vehicles has specific features from a legal and tax perspective, and it is important to consider these features in light of the commercial drivers and dynamics of the particular structure.

Increasingly, transaction documents are governed by Luxembourg, as opposed to English or New York law, and Brexit has accelerated this trend in our experience. Private equity participants are increasingly comfortable with the limited partnership agreements of their flagship funds, investment or shareholders' agreements of their co-investments, joint ventures or MIPs and share purchase agreements governing their exits or acquisitions to be governed by Luxembourg law and submitted to Luxembourg courts or arbitration.

The general principle under Luxembourg law is one of contractual freedom. However, there are some constraints that parties must bear in mind: basic contract law requirements such as ensuring that the rights and obligations of the parties are determinable, limiting the agreements and certain specific clauses in time, ensuring that transfer restrictions and voting undertakings are enforceable, the good-faith principle and avoiding penalties or conditions that are under the subjective control of the party seeking to rely on them.

Regardless of the governing law, Luxembourg corporate law requirements have to be taken into account, and can often have a significant effect. Corporate law issues that regularly arise on private equity structures include the rules and procedure around mergers and demergers, pre-emption rights, authorised share capital, the requirement for consent to transfer to third parties, the inability to have weighted voting rights at board level, the equal treatment of shareholders, the rules against abuse of assets, the requirement to obtain majority thresholds within each share class where the rights of holders of a particular class are adversely affected, the absence of a concept of alternate directors, conflicts of interest and financial assistance. Most market participants will be familiar with these concepts.

Another issue that frequently arises is the 'substance' of a Luxembourg entity. This is relevant from a tax perspective, but also from a corporate perspective. Luxembourg adopts a 'real seat' rather than 'incorporation' theory, meaning that a company that is incorporated as a Luxembourg company can migrate to a different country by virtue of the shifting of its place of effective management. Care must be taken to maintain effective management in Luxembourg – Luxembourg-resident board members and physical board meetings, supported by robust convening processes and minute-taking.

Checking the substance of a target Luxembourg company is one of a number of due diligence issues that often arise on acquisitions of Luxembourg companies. Others include:

a title and compliance with laws – ensuring that the company's incorporation and subsequent corporate actions have taken place in accordance with the law, and that the shares and any other instruments have been validly issued and are held by the seller free from encumbrances;
b ensuring that the relevant consents to transfer are identified and obtained;
c ensuring that the company is in good standing and is up-to-date with its filings, including the approval and filing of its annual accounts; and
d solvency.

In relation to this last item, Luxembourg does not have a balance sheet solvency test, but rather a Luxembourg company is insolvent if it is unable to pay its debts when they fall due and it has lost its 'creditworthiness'.

ii Fiduciary duties and liabilities

The governance of Luxembourg companies has become increasingly sophisticated over the years. The use of two-tier board structures, committees, observers, the delegation of specific powers to specific individuals or groups of individuals, the granting of daily management powers and the use of reserved matters are all common in private equity structures. Most Luxembourg companies will be subject to a conflict-of-interest regime and board composition, quorum and voting thresholds must be structured with attention to the definition of a conflict of interest.

Board members of Luxembourg companies are subject to a range of duties and, as a general rule, owe those duties to the companies to which they have been appointed and not to the shareholders who appointed them. In certain circumstances, board members may take into account the interests of other group companies, but the 'corporate interest' in doing so has to be assessed on a case-by-case basis, including the extent to which the relevant action is expressly set out in the corporate object of the company, the financial means of the company, the materiality of the relevant matter relative to those means, the extent of any remuneration to be obtained by the company and other relevant factors. Director and officer insurance, and indemnities are very common, as is the granting of 'discharge' to board members at the annual general meeting of shareholders and at exit.

We have yet to see frequent use of 'fairness opinions' in private equity deals in the same way as they are used in other jurisdictions. Luxembourg law requires valuations to be prepared in certain circumstances; for example, upon a contribution in kind of an asset to certain types of Luxembourg company. But there is no general trend towards boards obtaining fairness opinions to support their decisions on exits.

Shareholders of Luxembourg companies do not owe fiduciary duties to the companies in which they participate. However, parties to Luxembourg law-governed contracts do owe a general duty of good faith, and there are rules against abuse of corporate assets and similar minority protections.

It is often crucial to ensure that liability with respect to a particular investment, external financing or joint venture arrangement is blocked and managed at an appropriate level, away from the flagship fund or master holding company. Piercing the corporate veil (i.e., a shareholder becoming responsible for the liabilities of a limited liability company) is rare under Luxembourg law, and parties can have confidence that in the absence of a dissolution, merger or similar form of corporate transaction whereby one entity absorbs the assets and liabilities of another, and as long as the relevant company has normal governance and is managed in a manner that is independent of its shareholders, the liability blocker will be effective. This being said, during 2020 as a result of some of the distress caused by the covid-19 pandemic, we have seen a number of situations develop in which contractual counterparties sought to circumvent the structural liability blocker by claiming, on the basis of tort, against the shareholder, indirect fund or even investment manager of the fund. These situations underscored the importance of proper governance at all times, including during an era when travelling to Luxembourg may be difficult or impossible.

The Luxembourg securitisation vehicle (i.e., a company that is subject to the Luxembourg securitisation act of 22 March 2004, as amended) goes one step further and allows for statutory segregation or ring-fencing of compartments: investors in and creditors of one compartment may not sue on the assets of another compartment. The Securitisation Act 2004 also expressly recognises the validity of limited recourse, subordination, non-seizure and non-petition provisions.

III YEAR IN REVIEW

i Recent deal activity

The main development in recent years in Luxembourg has been the new Companies Act in 2016 and its subsequent 'bedding in', as market participants become familiar with its practical impact. One area that has been the subject of significant attention in contractual documentation and articles of association is the 'Section 189 issue' (now Section 710). Section 710, as it is now, applies to Sàrls and, as well as requiring transfers to third parties to be approved by shareholders representing three-quarters of the share capital, gives shareholders a right to exit by offering their shares to other shareholders or to the company at a price that is set out in the articles or, if no price is stated, at a price to be determined by a court. This may be inconsistent with the commercial intent of the parties and, if that is the case, a number of possible solutions can be deployed. Some market participants simply retain the Section 710 mechanism but state a low price, thus disincentivising its use.

An increasingly important structuring driver is speed. The ability to move quickly is often key to winning sale processes, and to be able to do so while preserving good governance, strong information flows and processes have to be put in place. Relevant corporate bodies must have the information and time that they require to make an informed decision on a particular matter, and once that matter has been approved it has to be implemented quickly: cash often has to flow down a structure in a matter of hours. Often, that cash is injected into a Luxembourg company as a combination of debt and equity. On the equity side, the issuance of share capital in most types of companies (excluding certain funds) requires an extraordinary general meeting before a Luxembourg notary, additional notary know-your-customer formalities and the blocking of the subscription monies pending the issuance of shares. Often, this has to take place at multiple levels. In response, certain market participants make use of the 'capital surplus' or 'equity reserve account' procedure, which is intended to constitute equity without the issuance of shares and avoid the need for a notary. This is not a mechanism that is set out in the law and it should only be used with appropriate and specific accounting, tax and legal advice. Certain market participants have moved or are moving away from this mechanism and instead use a form of convertible 'shareholder advance' to solve the logistical constraints involved in issuing share capital. The shareholder advance is converted or capitalised into the relevant mix of share capital (with or without issuance premium) and debt as soon as possible following the actual flow of funds.

There have been a number of recent developments in Luxembourg tax law, in particular the implementation into Luxembourg domestic law of the EU Anti-Tax Avoidance Directive (ATAD 1),[2] which may have an impact on Luxembourg companies that are used in private equity transactions.

The law implementing ATAD 1 into Luxembourg tax law (the ATAD 1 Law) was passed by the Luxembourg parliament on 18 December 2018. Most of the provisions of the ATAD 1 Law have applied since 1 January 2019 to accounting years starting on or after this date. The Luxembourg legislature has endeavoured to retain the most flexible options granted by ATAD 1 but without leaving the framework designed by the European Union.

The ATAD 1 Law contains, inter alia, a general interest limitation rule, which provides that taxpayers are only able to deduct 'exceeding borrowing costs' incurred up to 30 per cent of the taxpayer's earnings before interest, taxes, depreciation and amortisation. Exceeding borrowing costs are deductible borrowing costs that exceed taxable interest revenues and other economically equivalent taxable revenues the taxpayer receives. Exceeding borrowing costs that cannot be deducted in a given period by application of this new interest limitation rule, as well as unused interest capacity, may nevertheless be carried forward.

In accordance with ATAD 1, the ATAD 1 Law grants taxpayers a *de minimis* threshold of €3 million to deduct exceeding borrowing costs. The ATAD 1 Law has further introduced a grandfathering rule for loans granted before 17 June 2016, a carve-out for public long-term infrastructure projects, a carve-out for financial undertakings, including securitisation undertakings, as defined under Regulation (EU) 2017/2402,[3] and a carve-out for standalone entities, which are entities that are not part of a consolidating group for financial accounting purposes and have no associated enterprise or permanent establishment situated in a country other than Luxembourg.[4]

This new interest limitation rule may, under certain circumstances, result in additional taxation at the level of Luxembourg companies involved in domestic leveraged buyout transactions, as interest on internal and external debt will no longer be fully deductible. The Luxembourg government's proposal to retroactively amend the new interest limitation rule to allow the Luxembourg taxpayers to opt for the application of the new rule at the level of tax unity should thus be welcomed.

Back-to-back arrangements involving financing companies are not affected by the new interest limitation rule, in the absence of any exceeding borrowing costs.

The ATAD 1 Law has also introduced into Luxembourg domestic law a new general anti-abuse rule (GAAR) and a controlled foreign company rule (CFC). The new definition of abuse of law under the GAAR should facilitate the tax authorities' burden of proof given that the tax authorities will only have to prove that one of the main purposes of an arrangement is to obtain a tax advantage. The CFC rule has the effect of including certain non-distributed income of low taxed subsidiaries and branches of a Luxembourg company in the company's Luxembourg corporate income tax base. The impact of both the GAAR and CFC for Luxembourg companies involved in private equity investments will have to be assessed on a case-by-case basis, as these rules rely on factual considerations rather than on an objective

2 Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market.

3 Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017.

4 The Luxembourg tax authorities have very recently issued a circular, which provides useful clarification on the scope of these carve-outs (Circular No. 168-bis/1 issued on 8 January 2021).

test. Indeed, the CFC provides for a substance carve-out for controlled foreign companies carrying out a substantive economic activity. With respect to the GAAR, the taxpayer should also be able to avoid the application of the rule if it can demonstrate, in accordance with existing Luxembourg and EU case law, that the arrangement is genuine with regard to all the relevant facts and circumstances, meaning that the arrangement has been put in place for valid economic reasons outweighing the tax advantages of the arrangement.

Finally, the ATAD 1 Law has also implemented into Luxembourg domestic law an anti-hybrid rule, as provided under ATAD 1, which initially applied in a pure EU context only. The anti-hybrid rule under ATAD 1 was subsequently amended in 2017 by the second EU Anti-Tax Avoidance Directive (ATAD 2).[5] ATAD 2 has, in particular, clarified the material scope of the anti-hybrid rules and has extended these rules to hybrid mismatches involving third countries.

The law implementing ATAD 2 into Luxembourg tax law (the ATAD 2 Law) was passed by the Luxembourg parliament on 20 December 2019. Most of the provisions of the ATAD 2 Law have applied since 1 January 2020 to accounting years starting on or after this date, except for the rule on reverse hybrid mismatches, which will apply from 1 January 2022.

The anti-hybrid provisions introduced by the ATAD 2 Law target hybrid mismatches (i.e., different characterisation of a financial instrument or an entity) giving rise to a situation of deduction without inclusion or double deduction in the context of a structured arrangement or between associated enterprises. These rules may, under certain circumstances, result in additional taxation at the level of the Luxembourg companies that are used in private equity transactions, in particular for those companies carrying out intragroup financing activities. The application of these provisions in the context of investment funds needs to be monitored closely, as there are a number of uncertainties in the ATAD 2 Law and lack of guidance as regards the interpretation of a number of concepts. The potential impact of these provisions would, in any case, need to be assessed on a case-by-case basis.

ii Financing

Whether they are acquiring assets within Luxembourg or beyond, private equity funds typically obtain external finance. Luxembourg benefits from a strong but flexible legal framework when it comes to the options for financing private equity transactions. Sponsors can choose from a wide range of financing methods, which vary from equity or equity-linked instruments to hybrid instruments and pure debt instruments.

Standard bank financing remains the preferred method of financing and normally accounts for the major part of the funding of a private equity transaction. Private equity transactions up to €200 million are commonly financed solely by one major international bank. On larger deals, borrowers often approach syndicates to raise the required funds. Although these bank loans normally do not originate in Luxembourg, the borrowers, guarantors and obligors are often Luxembourg-based companies. In recent years, Luxembourg-based alternatives such as debt funds provide an increasingly attractive complement to the standard bank loans, as those funds can often offer better terms.

Issuances of high-yield debt securities are becoming increasingly popular and they offer great flexibility. This method of financing attracts less public attention as compared to standard loans but opens the door to the international capital markets and, therefore, also

5 Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries.

to additional capital. The Luxembourg Stock Exchange (LuxSE) is very competent and most high-yield debt securities are either listed on the regulated market or on the Euro MTF of the LuxSE. Recently, the LuxSE added a third listing venue – the Securities Official List (SOL). An admission to SOL is a pure listing without admission to trading. Listed securities will appear on the official list of the LuxSE. Admission to SOL is subject to compliance with a specific rule book, which provides for lower requirements in terms of disclosure and documentation compared to the documentation for listings on the regulated market of the Euro MTF market of the LuxSE. In addition, neither the Transparency Act nor the Market Abuse Regulation apply to SOL. It is, therefore, expected that this new listing venue will become popular for listings of high-yield debt securities.

Transactions that require a large amount of external funding are commonly financed by a combination of loans and bonds.

The Luxembourg Collateral Act (of 5 August 2005, as amended) provides a very robust and efficient framework to allow lenders and other creditors to protect their interests. The most frequent way of securing indebtedness in Luxembourg is by pledging the assets of the borrower and the assets of other members of the borrower's group. This can take the form of a pledge agreement over shares, receivables or bank accounts. The robustness of the Collateral Act is a key feature contributing to the attractiveness of Luxembourg as a major hub for European and global private equity transactions – many lenders insist on Luxembourg borrowers and will even have their preferred form of Luxembourg law-governed security documentation.

IV REGULATORY DEVELOPMENTS

Many of the domestic deals in Luxembourg are subject to regulatory approval and involve commitments being given by the private equity buyer to the relevant regulator. Sale processes are often specifically adapted to accommodate the requirements of the CSSF (the financial sector regulator) or the CAA (the insurance sector regulator) regarding client information. Electronic data rooms must be used carefully, and they are often combined with physical data rooms and staggered disclosure. Otherwise, sale processes involving Luxembourg targets will be familiar to the international buyer – there are few local idiosyncrasies. Warranty and indemnity insurance is increasingly popular.

From a tax perspective, the Luxembourg government has announced a welcome amendment to the law; namely, a modification to the law introduced at the beginning of 2019, with a retroactive effect as of 1 January 2019, to allow Luxembourg taxpayers to opt for the application of the interest limitation rule at the level of a tax unity.

V OUTLOOK

Looking ahead, we expect to see Luxembourg continue to develop as a private equity hub. While domestic private equity M&A activity is unlikely to increase dramatically, because of the limited number of potential targets (notwithstanding the high levels of interest from potential buyers looking at assets in the funds sector), the buying and selling of Luxembourg holding companies and the general use of Luxembourg investment platforms for deploying capital in private equity deals is accelerating, as is the size of managers' teams on the ground and the use of Luxembourg law in transaction documents. We expect these trends to continue.

Chapter 9

NORWAY

Peter Hammerich and Markus Heistad[1]

I OVERVIEW

i Deal activity

The Norwegian economy is, to a large degree, directly or indirectly, exposed to the oil and gas extraction and related industries. The Norwegian economy was less affected than other countries by the consequences of the financial crisis of 2007–2008 and the subsequent sovereign debt issues in Europe, in part because of the income it derived from oil and gas extraction. However, the substantial reduction in the price of oil that started in 2014 (from US$115 per barrel in June 2014 to approximately US$30 at the start of 2016, since levelling out at around half of its 2014 high)[2] had quite immediate effects in the Norwegian 'real' economy. This led to severely reduced investment activity, lay-offs of personnel and debt restructuring in the oil-related sectors. Although the sector has mostly successfully restructured to the new level of oil prices, investment activity has more recently seen signs of abating following the decision of some investors to 'decarbonise' their portfolios as part of their sustainability strategies, a trend that may be set to strengthen as the European Union (EU) Taxonomy Regulation enters into force in the coming year. Future investor appetite for the sector will be important for its development. Lower investments may also drive up oil prices and potential return.

With respect to investments made by funds advised by Norwegian sponsors,[3] there was a sharp drop from top levels in 2016 of 12 billion Norwegian kroner to 8.5 billion Norwegian kroner in 2017, levelling out at 8.1 and 8.3 billion Norwegian kroner in 2018 and 2019, respectively. 2019 did see record high total investments of 32 billion Norwegian kroner, but where foreign funds composed 83 per cent. There were no public-to-private deals (of any significance) in 2018 or 2019. However, in 2020, game developer Funcom was delisted having been acquired by Chinese Tencent, and NextGentel was delisted in 2019 subsequent to acquisition by its large investor Kistefos.[4]

The number of private equity exits by funds advised by Norwegian sponsors continued its downward trend from 39 in 2017 (and 39 in 2016) to 31 and 32 in 2018 and 2019, respectively.[5]

In 2018, government-backed venture investor Investinor (see below) partially exited poLight through an initial public offering (IPO), as was the case for fitness group Sats Elixia,

1 Peter Hammerich is a partner and Markus Heistad is a senior lawyer at BAHR.
2 Official Brent Oil prices.
3 Definition by the Norwegian Venture Capital & Private Equity Association (NVCA).
4 BAHR internal study.
5 NVCA, Private Equity Funds in Norway – Activity Reports 2016, 2017, 2018, 2019.

previously controlled by Altor. There has been a lasting decline in the number of exits being made in the form of an IPO, mirroring a decline of the Oslo Stock Exchange as a source for risk capital. This trend may indicate that IPOs are not seen as being as viable an exit route as previously in the Norwegian market, except in exceptional cases. Listings on the main exchange have also been eclipsed by listings on the multilateral trading facility Merkur Market under the Oslo Børs umbrella. In 2019, Oslo Børs was acquired by the French Euronext group, and will become more integrated with the Euronext capital market infrastructure and has migrated to the Euronext trading platform.

As at the start of 2021, a total of 205 Norwegian alternative investment fund managers were registered or authorised by the Financial Supervisory Authority of Norway, compared to 167 the year before and 147 in 2018.[6] Approximately half are private equity managers. The exact number of alternative investment funds established in Norway is unclear, as some private equity funds will still be covered by the grandfathering rules under the Alternative Investment Fund Managers Act (the AIF Act), implementing the EU Alternative Investment Fund Managers Directive (AIFMD). The recent increase in numbers is likely also related to the fact that the regulator has stated that it views single asset funds (which has been an important asset class within real estate in Norway) as within the scope of the AIF Act.

From the point of view of investing activity, the Norwegian private equity scene may be divided into five main categories. The first category consists of (in a Norwegian context) relatively large generalist private equity investors, such as FSN Capital, Norvestor Equity and Herkules Capital. The second category consists of sector-specialist investors, such as HitecVision, Energy Ventures and Hadean, the first two focusing on technology and assets connected to the exploration of oil and gas, and the latter a healthcare specialist. In the third category are a number of smaller sponsors in the venture and seed capital segments, such as Proventure and Sarsia.

As a fourth category, some Stockholm and Helsinki-based managers are active in the Norwegian market to the extent of having established offices in Norway (e.g., EQT, Altor, Nordic Capital and Northzone). International private equity funds are highly active in the Norwegian market, in which investments are largely unrestricted. A notable example is Partners Group's acquisition of CapeOmega, an owner-participant in the Gassled transportation, storage and processing infrastructure for gas from the Norwegian North Sea in 2019.

The fifth category is made up of government-backed actors, and chiefly Argentum Fondsinvesteringer AS. Argentum is a government-owned investment company investing in private equity. Argentum is active both in the primary and secondary markets, and in completing co-investments with private equity funds, and it is a significant investor in most Norwegian and Scandinavian venture and private equity funds. Argentum has expanded its geographical investment area outside Scandinavia. In the venture segment, the government has established Investinor AS, an investment company for venture investments. As at the third quarter of 2020, the investment portfolio of Investinor AS amounted to 3.1 billion Norwegian kroner. Investinor has financial assets and a commitment from the government amounting to 4.3 billion Norwegian kroner, and had its equity increased through a capital injection of 350 million Norwegian kroner by the government in 2019.[7]

6 Financial Supervisory Authority of Norway (FSAN) register.

7 Source: Investinor AS, Q3 2020 report.

There were few new fund sponsors in Norway in 2020, Equip Capital being one exception in a year in which fundraising efforts were impeded by the effects of covid-19.

ii Operation of the market

Management incentive schemes

A key element of private equity investing is appropriate incentive schemes aimed at key personnel both at the fund (sponsor) and portfolio company levels.

In Norway, incentive schemes at the sponsor level, aimed at key personnel of the manager, have traditionally been equity-based and modelled on traditional incentive schemes in the international private equity industry. The specific structuring of sponsor management equity schemes will vary from case to case depending on, inter alia, the relevant legal framework applicable to the manager, and on the participants and choice of investment model. Norwegian fund managers authorised under the AIF Act are subject to remuneration rules that may affect incentive schemes that are not investment-based (carried interest).

At the portfolio company level, it is common practice for private equity funds to require key employees of a portfolio company to reinvest alongside the fund in connection with a fund's acquisition of the company. Incentive schemes aimed at such key employees have evolved over the past years, migrating from option-based and bonus-based models to almost exclusively investment-based models.

In some cases, key employees invest on the same terms as the fund, with their investment exposed to the same risk. However, it is not uncommon that the employees' investment implies greater risk than the fund's investment, and also that the investment has the potential for a higher relative return. This is normally achieved by establishing different classes of shares in the company, the financial terms of which are often similar to the terms that are common for private equity funds (i.e., a carried-interest model). A common structure is to establish two classes of shares with different risk and return profiles. The share class with lower risk and potential for return (preferred shares) is predominantly subscribed by the fund, while the share class with higher risk and potential for return (subordinated shares) is subscribed by leading employees and, in some cases, the fund.

The exact terms of leading employees' investments differ between funds and individual portfolio companies. It is, however, possible to identify certain basic principles that apply in some form in most cases. For instance, it is customary that the terms applicable for the preferred shares state that the fund shall be entitled to receive the entire amount it has invested, plus a predefined return on the investment (the preferred return), before the subordinated shares become entitled to any distributions, hence the greater risk on the employees' investment. After the fund has received its preferred return, each subordinated share will be entitled to receive a higher amount of excess distributions than each preferred share, hence the higher potential for return on the employees' investment.

Normally, leading employees that own subordinated shares are subject to certain restrictions and obligations that do not apply to preferred shares. These include transfer restrictions and obligations such as lock-up and standstill for a predefined period, right of first refusal for the fund and drag-along obligations (employees normally also have tag-along rights). It is also common that leading employees are subject to good-leaver and bad-leaver provisions, and enter into restrictive covenants such as non-compete and non-solicitation undertakings, and restrictions on other business interests and engagements.

On 1 January 2017, new legislation concerning non-compete clauses and certain types of non-solicitation clauses in employment contracts entered into effect. Under these rules, non-compete and non-solicitation clauses were made subject to several limitations in employment contracts. Among other things, non-compete clauses require compensation and such clauses may not extend longer than 12 months from the end of the employment. Exceptions may be agreed for the CEO (only). These new restrictions mean that non-compete and non-solicitation clauses should be addressed fully in the shareholder agreements for management incentive schemes and be linked to the status as an investor.

Private equity divestments

The terms of divestments made by private equity funds will differ from case to case and generally between segments (venture, growth, buyout). The attractiveness of the target company will often be a dominant factor as to whether a sales process runs smoothly and quickly. Exits through IPOs are fewer now than prior to the financial crisis, except for exits in smaller companies to the multilateral trading facility Merkur Market. Consequently, most exits take the form of a secondary sale to other private equity investors or trade sales to industrial actors.

As a general rule, divestments by Norwegian funds are made through structured auction processes targeting a limited number of potential buyers. It is good practice for the manager to formulate exit plans in connection with the original investment in the portfolio company, and also throughout the term of the investment as the relevant portfolio company and market conditions develop. For authorised AIFMs, this is a legal requirement. Buyers will, depending on the target company in question, consist of industrial actors or other funds, or a combination thereof. The time and effort necessary to complete a divestment, as well as the terms that may be obtained by the divesting fund, will vary greatly depending on the size and other characteristics of the portfolio company and the prevailing market conditions. In the first half of 2020, the covid-19 pandemic generally brought the M&A markets to a halt. As sponsors managed to grapple with the uncertainties and on the back of public finance measures such as deferral of taxes and VAT, 2020 overall represented a less significant reduction in deals than previously. Most importantly, deals have shifted to other sectors than previously, and especially to deals within the IT sector.

Authorised AIFMs (when investing in assets of limited liquidity preceded by a negotiation phase, as is typically the case for private equity investments) are required to establish and update a business plan for the investment in accordance with the duration of the fund with a view to establishing exit strategies as from the time of the investment. While most private equity fund managers would expect to put such a plan in place as a fundamental aspect of the investment process, the AIFMD requires this as a statutory duty.

II LEGAL FRAMEWORK

i Acquisition of control and minority interests

The investment objective of private equity funds is generally to achieve superior returns through control in its portfolio companies. In this section, we provide a brief description of the legal framework for a control investment in Norwegian public and private limited companies. Our discussion is limited to equity investments (we do not discuss asset transactions).

Listed companies are a subset of public companies. The regulatory regime applicable to takeover offers on shares differs significantly, depending on whether the target company is listed on a regulated market or not. Acquisition of controlling stakes in listed companies triggers particular requirements.

Norway has implemented the EU Takeover Directive[8] through rules in the Norwegian Securities Trading Act, which applies to Norwegian and (subject to certain exemptions) foreign companies listed on a Norwegian regulated marketplace (currently the Oslo Stock Exchange or Oslo Axess). The takeover rules distinguish between voluntary and mandatory offers. A voluntary offer, if accepted by the recipients of the offer, triggers a mandatory offer obligation for the buyer. A mandatory offer for the remaining shares in the target is triggered if the buyer (either through a voluntary offer or otherwise) becomes owner of more than one-third of the voting rights in the target (with repeat triggers at 40 and 50 per cent). Further, Norway has implemented the EU Transparency Directive[9] through rules in the Norwegian Securities Trading Act, requiring major shareholding notifications. Norway has yet to implement the revised EU Transparency Directive (as amended through Directive 2013/50/EU). This is expected in 2021.

In the case of an unlisted target company (whether the target is a public or private limited company), the buyer is to a large extent free to determine the process pursuant to which a takeover shall be executed, subject to what may be agreed on a contractual basis with the target or the target company's shareholders.

EU fund managers that are authorised under national legislation implementing the AIFMD and non-EU fund managers that hold a marketing authorisation in an EEA Member State are subject to certain reporting requirements when investing in unlisted companies that are not small or medium-sized enterprises (SMEs).[10] Such managers shall notify the regulator whenever the proportion of voting rights of the non-listed company held by the fund or funds under management reaches, exceeds or falls below the thresholds of 10, 20, 30, 50 and 75 per cent. Additional disclosure requirements are triggered upon acquiring control in the relevant company (which also applies when the company is listed). Investments by funds managed by EU fund managers authorised under national legislation implementing the AIFMD or by non-EU fund managers holding a marketing authorisation in an EEA Member State in unlisted (non-SMEs) and listed companies where the funds have acquired control of the company are also subject to rules concerning asset stripping. These rules contain certain restrictions on distributions, capital reduction, share redemption and acquisition of own shares for a period of 24 months from the acquisition.

According to Norwegian merger regulations, all mergers and transactions involving acquisition of control (concentration) must be notified to the Norwegian Competition Authority if the undertakings involved in the transaction have a combined annual turnover in Norway of 1 billion Norwegian kroner or more, and at least two of the undertakings concerned each has an annual turnover exceeding 100 million Norwegian kroner. An automatic standstill period applies to all concentrations subject to the notification requirement, until the Competition Authority has concluded its handling of the case. If the transaction is of a magnitude that requires merger clearance at EU level, the Norwegian filing requirements are suspended and absorbed by the EU rules.

Acquisition of substantive holdings or control in a target company may also trigger other filing, concession or approval requirements under Norwegian or foreign legislation.

8 Directive 2004/25/EC.

9 Directive 2004/109/EC.

10 Enterprises that employ fewer than 250 persons and that have an annual turnover not exceeding €50 million, or an annual balance sheet total not exceeding €43 million, or both.

These aspects must be assessed on a case-by-case basis. In Norway, this applies within, for example, the financial sector, fisheries, oil extraction and certain infrastructure, such as production or transfer of electricity.

The above rules apply independently of the jurisdiction of establishment of the investing fund. However, the jurisdiction of establishment of the investing fund will be among the considerations relevant to the choice of structuring of an investment to obtain a structure that is suitable from the point of view of the business and exit plans for the target company, as well as the prevailing tax laws.

ii Fiduciary duties and liabilities

Private equity sponsors or managers are not subject to any specific fiduciary duties or similar duties to other shareholders in portfolio companies. However, Norwegian company law provides for shareholder minority rights in Norwegian public and private limited companies.

Minority shareholders in Norwegian public and private limited companies are conferred certain rights under Norwegian company law. The most significant restriction upon majority shareholders is the principle of equal treatment. This implies that the majority shareholder 'cannot adopt any resolution which may give certain shareholders or other parties an unreasonable advantage at the expense of other shareholders or the company'.[11]

With respect to transactions with shareholders, the principle does not mean that all shareholders have to be treated equally at all times. Generally, differential treatment is acceptable if this can be justified based on objective grounds and the best interests of the target company as a whole.

Majority shareholders that are private equity funds should be aware that the Norwegian rules on financial assistance became more flexible with effect from 1 January 2020. The changes imply, inter alia, that a European Economic Area (EEA) or EU-based parent company now may acquire shares in a Norwegian company with financial assistance from such company without a limitation equal to such company's dividend capacity (which is the general rule). The exemption applies irrespective of whether the parent company already is or becomes a parent company because of the transaction to which the financial assistance relates. Procedural requirements must still be followed, and the financial assistance must be on market terms.

In the case of payment of financial assistance to a group company, the minority shareholders may claim payment of an equal dividend. If the general meeting decides not to pay out a dividend, the minority shareholders may challenge this decision in court.

Minority shareholder rights will normally be supplemented by the more specific provisions of a shareholders' agreement between the private equity fund and the minority shareholders (e.g., members of management) concerning rights at exit, etc.

Potential liabilities for majority shareholders

Norwegian limited company law provides for the liability of board members, members of management and shareholders for losses in the hands of the company in the event of negligent or wilful acts or omissions. The provisions of the limited company acts only provide for damage suffered by the company, and not by third parties (although third parties may, in priority, file claims on the company's behalf).

11 The Private Limited Company Act and Public Limited Company Act, Sections 6–28.

Shareholders of a limited company may also be held liable for claims by third parties (piercing the corporate veil) in some cases. The legal basis for such claims is based on unwritten and customary law and is, to our knowledge, without legal precedent in Norway. However, case law provides that there are circumstances where the court will be prepared to come to the conclusion that shareholders are personally liable. This does not, in itself, abolish the company's position as a separate legal entity; rather it is a form of shareholder liability. Although each case will depend on the court's assessment of the particular circumstances, the court has come to such conclusions where, inter alia, a shareholder or secured creditor has a right of control over the company so that the company is in reality not organisationally or financially independent, as required by the Norwegian private limited companies act, the company has been under-capitalised compared to the financial risk involved in its operations for a long time (under-capitalisation may not in itself be a legal reason to pierce the corporate veil, but may indicate the company is not sufficiently independent of its owners) or the company's funds have been used against its interests to benefit its shareholders.

Rights of stakeholders

As a general rule, Norwegian law does not confer any legal rights on other stakeholders that are legally binding upon the members of the board of directors of a limited company. The obligations of the board members (their fiduciary duties) are to the company and to the shareholders.

Structuring exits

Private equity investments are by nature temporary, and any acquisition by a private equity fund is made with the objective of a future exit. Acquisitions will normally be organised with the exit in mind, including measures to avoid complications because of minority shareholder rights (discussed above). Authorised AIFMs are required to adopt exit plans in connection with the original investment in the portfolio company and also update them throughout the term of the investment.

The time and effort necessary to complete a divestment, as well as the terms that may be obtained by the divesting fund, will vary greatly depending on the size and other characteristics of the portfolio company and the prevailing market conditions. Depending on the development of the relevant portfolio company or the prevailing market conditions, an exit may not be made as initially planned or set out in the exit plan; the manager may also identify more commercially interesting forms of exits at a later stage. This implies that an exit will normally require bespoke structural and legal measures.

With the exception of general contract, company, tax and competition law, few general rules govern an exit of a portfolio company. If an exit is made in the form of an asset sale, then labour law will be relevant, as the employees of the business to be transferred are conferred certain rights under Norwegian labour law. Under current Norwegian tax legislation, equity transactions will normally be treated more favourably than asset transactions.

III YEAR IN REVIEW

i Recent deal activity

Following an all-time high in 2016 of 11.9 billion Norwegian kroner invested by funds advised by Norwegian sponsors, led by investments in the buyout segment, the figure declined to 8.5 billion Norwegian kroner in 2017 and 8.1 and 8.3 billion Norwegian kroner in 2018 and 2019, respectively.[12]

There were few large transactions made by Norwegian private equity sponsors in 2019 and 2020. In total, 32 divestments were made by such sponsors in 2019. Norvestor was among the first Norwegian sponsors to carry out a roll-over exit of IT company Cegal, spun out from their fifth fund to a special purpose vehicle managed by Norvestor. Although the uncertainty introduced by Covid-19 remained a constant for 2020, the number of transactions was largely on a par with the year before, with a large uptick towards the end of the year.

The long-term trend seems to be for transactions that are largely Nordic-centric, with Nordic private equity sponsors typically investing in the Nordic countries, followed by US and UK actors. The telecoms, business services and petroleum sectors dominate transactions overall. For a period following the fall in oil prices, retail was also an attractive sector for private equity investors. During 2018, a number of retail chains began facing financial difficulties, a trend that has increased in strength in 2019 leading to bankruptcies of several high street retail chains that are also private equity owned (e.g., beauty products chain Vita). Covid-19 has had mixed effects on brick and mortar-based businesses. Social distancing has represented a major push towards online shopping, but large parts of the workforce working from home has led to a push for goods for the home (furniture, refurbishing, etc.).

ii Financing

One of the main consequences of the financial crisis and the ensuing sovereign debt problems of European and other countries has been a relative decline in the availability of banking finance for private equity transactions and similar transactions.

Traditionally, Norwegian sponsors have leveraged buyouts to a lesser degree than sponsors in other jurisdictions. In addition, Norwegian banks have been less affected by the market turmoil since the financial crisis than many European counterparts. The relatively minor role of non-bank financing is also related to the fact that lending is a regulated activity in Norway, which only banks and regulated financing undertakings may carry out. This means that Norwegian private equity funds have been affected to a somewhat lesser degree by the shifting credit market. The main source of finance in leveraged acquisitions is therefore still bank financing, but mezzanine financing has been used in some deals.

Terms for bank financing are highly standardised, but the content of covenants will differ from case to case based on, inter alia, the financial position and business of the target company.

iii Key terms of recent control transactions

The terms of control transactions made by Norwegian private equity funds will vary greatly. In public-to-private deals, the rules on voluntary and mandatory bids, as well as a (normally) fragmented shareholder base, will mean that few terms will be set in such transactions.

12 NVCA, Private Equity Funds in Norway – Activity Report 2018 and 2019.

In purely private transactions, terms will as a rule be confidential. The disclosure rules under the AIF Act with respect to acquisitions of control, applicable to certain AIFMs, do not require the disclosure of the terms. However, the timing of such acquisitions may become public knowledge faster than before. Norwegian private equity sponsors will consistently structure deals and set terms to obtain control in the portfolio companies with a view to exercising active ownership in the portfolio investments. As a rule, sponsors will seek to obtain control through a majority stake (50.1 per cent or higher) or through shareholders' agreements granting the sponsor the right to appoint the majority of the board. Such shareholders' agreements will routinely contain provisions concerning drag-along and tag-along rights, to achieve an appropriate exit, as well as to accommodate co-investment opportunities for management.

iv Exits

The downward trend in investment activity in the exit activity has flattened the last few years. The number of exits by funds advised by Norwegian sponsors has declined from 79 in 2013 (the most recent high point) to 43 in 2017, to settle on 31and 32 in 2018 and 2019, respectively.[13]

IV REGULATORY DEVELOPMENTS

In Norway, the AIF Act, implementing the AIFMD, came into force on 1 July 2014. Before that, private equity funds were outside the scope of any specific regulatory regime in Norway. Now, the AIF Act regulates management of private equity funds, and the marketing of interests in such funds. The majority of Norwegian private equity managers have assets under management below the threshold values requiring authorisation (€100 million or €500 million, depending on the fund terms). A number of managers are affected by the authorisation requirement, which is also triggered by cross-border management or marketing, or when marketing units in funds to non-professional investors in Norway, while some have elected to operate on a purely offshore basis with Norwegian advisory hubs.

In Norway, private equity funds are still unregulated at the fund level. Although the AIF Act is aimed at managers only, certain provisions have effect at the fund level. This concerns primarily the requirement to appoint a depositary, but also reporting and disclosure requirements. On 15 January 2019, the Ministry of Finance initiated a public consultation on the implementation of the amendments to the EU Regulation on European venture capital funds (EuVECA),[14] the EU Regulation on social entrepreneurship funds (EuSEF)[15] and delegated regulation under the EU Regulation on long-term investment funds (ELTIF).[16] None of the main regulations have entered into effect in Norway yet, and an amendment to the Financial Undertakings Act will be required to allow such funds to provide loans. The rules will, when implemented, introduce these regulated fund types in Norway. With respect

13 NVCA, Private Equity Funds in Norway – Activity Report 2016, 2017, 2018 and 2019.

14 Regulation (EU) No. 345/2013 of the European Parliament and of the Council of 17 April 2013 on European venture capital funds.

15 Regulation (EU) No. 346/2013 of the European Parliament and of the Council of 17 April 2013 on European social entrepreneurship funds.

16 Regulation (EU) 2015/760 of the European Parliament and of the Council of 29 April 2015 on European long-term investment funds.

to EuVECA and EuSEF funds, Norwegian registered managers will also be able to market interests in such funds to non-professional investors without being authorised under the AIF Act, in contrast to the current situation.

Authorised and registered managers established in Norway are supervised by the FSAN. The FSAN also has oversight over activities of non-Norwegian managers following marketing authorisations under the national private placement regime. The FSAN has, so far, shown limited concern for the investment activity and transactions carried out by funds managed by managers under its supervision. This seems to be a policy choice, as the primary focus of the FSAN has been on investor rights and fair treatment of investors. The FSAN is, however, concerned with financial stability and market integrity, but it has yet to pursue any matters related to transactions in unlisted instruments. The FSAN will typically carry out its duties through inspections of premises or document-based inspections. In the case of non-Norwegian actors, the FSAN will typically consider whether they have the proper regulatory authorisation to carry out any regulated activities in or into Norway. With respect to investing, this will typically relate to the question of providing loans to Norwegian debtors, as this is a regulated activity (see Section III.ii).

There is otherwise no specific regime with respect to private equity transactions, which are legally no different from transactions between any other parties. The structure of private equity funds may, however, have consequences with respect to their position under competition law. Further, private equity investors as major shareholders in Norwegian companies in the financial sector (which require a prior authorisation) are a somewhat novel development. Regulators may, therefore, be stringent about applicants meeting documentation requirements when filing necessary applications.

We expect the coming year to see the entry into force of Norwegian rules implementing the EU Sustainable Finance Disclosure Regulation (SFDR) and Taxonomy Regulations. The Norwegian Ministry of Finance has held a public consultation of its proposal for a law to implement the regulations, possibly before they are incorporated into the EEA Agreement. Although the rules do not – as a starting point – contain substantive investment restrictions, the spirit of the rules and the seeming appetite for environmental, social and governance (ESG) and sustainability products from institutional investors would likely require private equity sponsors to integrate ESG into their investment and risk management processes to a much higher degree than what has been the case to date, also affecting the work of service providers in transactions.

V OUTLOOK

Notwithstanding the market conditions affecting all investors, private equity investors are especially dependent upon professional and successful deal sourcing to be able to deploy committed capital and make divestments on optimal terms upon the prospect of the termination of a fund.

In the Nordic region, several private equity sponsors have significant amounts of uncalled capital, and this has – along with lower interest rates – raised prices for attractive targets. Norwegian insurance companies and pension funds are now both subject to Solvency II investment rules (since 2016 and 2019, respectively), and should – all else being equal – allocate more of their portfolios to long-term investments such as private equity. It remains to be seen how this will develop and whether the market will cater to such investors and provide the sought-after returns. Such investors could be expected to have extensive reporting-quality requirements (to satisfy Solvency II look-through rules) as well as ESG requirements.

The relative importance of bank financing over other financing sources may change going forward, as the effects of covid-19 will likely include a need for capital, and a need for investors to deploy capital in a low interest rate climate. Further, upon transposition of the EuVECA and ELTIF Regulations, the types of funds affected will be allowed to provide loans (within certain limitations). Norway has implemented the Capital Requirements Directive IV and the Capital Requirements Regulation with effect from 1 January 2020 (with certain transitional rules). This includes the small and medium-sized enterprises (SME) supporting factor – providing for a lower capital charge for exposures towards SMEs. The government has, however, resolved to increase the systemic risk capital buffer to 4.5 per cent, to introduce a floor for risk weights of exposures to real estate. This suggests that Norwegian banks may become less competitive as sources of debt financing in future, unless the authorities will find that financing of green technologies will require a more flexible approach.

The coming year will likely see the advent of statutory sustainability disclosure and reporting requirements in the private equity space. The Norwegian Ministry of Finance and the FSAN is focused on avoiding adverse effects of 'greenwashing' in the financial markets.

Norway has traditionally had a broad and deep economic relationship with the United Kingdom, both before and after the United Kingdom became a member of the EU. Norwegian fund sponsors eager to attract non-Norwegian capital have also often relied on the power of City of London-based placement agents. It remains to be seen how Brexit will affect these relations and investment activity, both in the United Kingdom by funds advised by Norwegian managers and of UK-based funds in Norway.

Chapter 10

PORTUGAL

Mariana Norton dos Reis and Miguel Lencastre Monteiro[1]

I OVERVIEW

i Deal activity

According to the 2019 European Private Equity Activity Report,[2] approximately €94 billion of equity was invested in European companies in 2019, with €65 billion relating to buyout investment. Growth investment, which is typically a minority investment in mature companies that are seeking primary capital to expand and improve operations or enter new markets to accelerate the growth of business, reached amounts close to €16 billion, meaning that seed, start-up and later-stage financing (venture capital) continues to make up – similarly to 2018 – a fraction of the total private equity investment made in the European market. In terms of geographical investment flows, the largest part of capital circulated inside the European territory, with €59 billion capital investment made domestically within European countries and €27.3 billion made in cross-border investments within Europe. The most targeted sectors were ICT (communications, computing and electronics), consumer goods and services and business products and services, with a combined share of approximately 69 per cent of all private equity investment made in Europe.

This conjuncture was reflected in Portugal, whose economic growth in 2019 affected its private equity market while maintaining similar distributions of investment by stage and sector.[3] In line with the growth trend of previous years, assets under management (sum of equity, financing, liquidity, options on derivatives and other private equity assets) reached €5.1 billion by the end of 2019, with a significant increase of €316 million (6.6 per cent) in comparison with the previous year. This positive development was mainly because of an increase in the number of equity funds operating in the Portuguese private equity sector (from 117 to 135). While the investment amount (i.e., the sum of equity and other investments) registered a slight increase (0.9 per cent in 2019), equity only accounted for 35.6 per cent of the total amount invested in the national private equity sector, while other investments appear as the major target in 2019 (albeit with a slight decrease in comparison with 2018), amounting to up to 64.4 per cent (€2.1 billion). Of these other investments, accessory contributions (€876.7 million), shareholder loans (€565.9 million) and other loans take on the largest role. In comparison with the previous year, investments in other assets (derivative positions and other assets) and equity increased by, respectively, 9.8 per cent

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2 Published by Invest Europe and available at https://investeurope.eu/media/3052/20200512_invest-europe-investing-in-europe_-private-equity-activity-2019-final.pdf.

3 www.cmvm.pt/pt/EstatisticasEstudosEPublicacoes/Publicacoes/CapitaldeRisco/Documents/CMVM-Relat%C3%B3rio%20Anual%20de%20Capital%20de%20Risco-2019.pdf.

and 17.6 per cent, mainly as a result of investments in domestic targets. The value of other investments decreased (6.5 per cent) for both domestic and non-domestic companies. On another note, investments through deposits and cash significantly increased by 43.6 per cent (from €440.3 million to €632.5 million).

Currently, there are 52 private equity companies and 164 private equity funds operating in the Portuguese private equity sector.[4] By the end of 2019, investments of these private equity funds totalled €4.9 billion, while investments of private equity companies amounted to €273.4 million. This shows that investment via private equity funds, comprising 94.7 per cent of the total investment in private equity assets in Portugal, is staggeringly more significant than via direct investment through private equity companies.

There continues to be a significant concentration of the Portuguese market, with 11 private equity funds representing around 54.7 per cent of total assets under management.

By the end of 2019, there were 916 equity participations, of which 32.9 per cent comprised 96.3 per cent of the global value of all equity participations. Conversely, 68.1 per cent of all equity participations – largely related to targets in the seed and start-up stages – solely amounted to 3.7 of the global value of all equity participations. There is only one equity participation exceeding €100 million.

As for the targets that private equity agents generally envisage, holding companies that manage non-financial corporations acting as vehicles for investments in other companies continued to be quite popular in 2019, as they allow end investments not to be disclosed. Excluding such holding companies (whose investment amounted to €960.6 million), the activities that captured the largest amounts of private equity investment in 2019 were the ICT (€453.5 million), real estate (€434.9 million) and hospitality and food services (€313.6 million) sectors, which jointly represent close to one-third of the total investment in private equity in Portugal. On the other hand, financial and insurance companies continue to gather the clear majority of investment made by private equity companies (approximately 85.1 per cent).

In respect of the stages of investment, private equity comprises 80.8 per cent of the total investment (–1.7 per cent in comparison with 2018), with the largest branch of this stage of investment being the turnaround (which represented 28.8 per cent of the total, but with a decrease (4.7 per cent) in comparison with 2018) followed by the expansion stage (22.9 per cent). The growth of both the expansion and the replacement capital stages rose from an aggregate proportion of 28.2 per cent to 32 per cent. Venture capital evidenced an increase in the investment amount (up to €664 million in 2019). At any rate, and contrary to the expectations occasioned by the multiple measures and incentives implemented by the Portuguese state, the start-up stage holds at 7.8 per cent of the total amount invested, as against 8.4 per cent in 2018.

Private equity investments differ in terms of management approaches between hands-on (technical supervision and management involvement) and hands-off (restricted to the allocation of funds). This distinction is also related to the level of control that the investor intends to exercise. By the end of 2019, 61.3 per cent of all investments concerned shareholdings under 30 per cent of the total share capital of the targets.

Concerning the duration of investments, nearly 27.9 per cent of private equity investment had a term of less than four years and 9.2 per cent were kept for more than 10 years.

4 http://web3.cmvm.pt/english/sdi/capitalrisco/index.cfm.

At the time of writing, the exact repercussions of the covid-19 pandemic on the private equity sector remain unclear. According to the available data, most notably the H1 2020 European Private Equity Activity Report,[5] the first half of 2020 was marked by an overall decrease in fundraising (–4 per cent), investments (–17 per cent) and divestments (–49 per cent) with regard to the first half of 2019.

It is expected that these levels were also reflected in Portugal. In fact, the country is currently facing an economic downturn largely linked to the pandemic, which has halted the trends of systematic growth registered in the past years.

ii Operation of the market

Management incentive arrangements

Management incentives may be structured as compensation schemes linked to predetermined performance thresholds, equity-linked participation programmes, granting managers the option to acquire shares at a discount or vesting mechanisms where shares are gradually 'unlocked' and offered to managers at a discount. Furthermore, exit bonuses are standard market practice for almost any private equity entity in Portugal. From a strategic point of view, equity incentives are a reliable source of interest alignment between the management and the company, constricting both parties to equal goals and targets.

Because management incentive arrangements are designed to intersect interests of both the management and the investors, general prohibitions (or severe restrictions) on the transferability of equity or the incentive itself are used to ensure that it is exclusively held for the benefit of management. This kind of mechanism is complemented by the fact that, in the event of change of management, the interest may be transferred back to the company or to the majority shareholder. For this purpose, 'good-leaver' and 'bad-leaver' provisions are used to adjust the vested equity accordingly.

Ratchet arrangements are mechanisms designed to align the amount of equity held by owner managers with the performance of the company after the initial investment. However, ratchet arrangements are not regulated under Portuguese law, and the question of whether the gains obtained from such arrangements are taxed as labour remuneration (and consequently subject to personal income tax and social security) or as capital gains is currently still under discussion and may vary according to the particular structure implemented.

II LEGAL FRAMEWORK

i Acquisition of control and minority interests

Portuguese law sets no restrictions – neither legal nor regulatory in nature – on the ownership of companies and assets by foreign entities or individuals, except for a foreign investment control screening (approved by Decree-Law No. 138/2014 of 15 September 2014) over particularly sensitive industry sectors, based on reasons of national defence and security and/or security of supply of services fundamental to the national interest. Indeed, the acquisition of direct or indirect control over main infrastructures and assets related to (1) national defence and security and/or (2) the supply of essential services in the energy, transport and telecommunications sectors, by nationals of a non-European Economic Area

5 Published by Invest Europe and available at www.investeurope.eu/media/3497/invest-europe-h1-2020-activity-report-final-28102020.pdf.

country, either an individual or legal entity, may trigger an investigation procedure by the cabinet member overseeing the relevant sector. Should the government ultimately determine that the acquisition might harm national interest by threatening either the country's security or its provision of fundamental services, the transaction may be deemed null and void. Even though this screening mechanism has been in place since 2014, to our knowledge it has not been enforced to date. Also, contrarily to what happened in other European jurisdictions, no 'covid-19 specific' foreign investment control legislation has been enacted to date.

Even though the national regime seems to be compatible with the Regulation (EU) No. 2019/452 of the European Parliament and of the Council dated 19 March 2019, which establishes a framework for the screening of foreign direct investments into the Union, and which came into force on 11 October 2020 (the FDI Regulation), it is clearly less restrictive, being possible the amendment of the screening mechanisms in Portugal to accommodate the EU's recent guidance on this matter.

In fact, it is already apparent that players involved in M&A transactions show an increasing concern about this type of screening when selecting bidders or preparing a bid for assets in strategic sectors.

Portuguese law sets some rules on group companies, which are relevant for the acquisition of minority and control interests. Indeed, according to the provisions of the Portuguese Companies Code, whenever a simple interest relationship is established (i.e., a company holds an interest equal to or greater than 10 per cent in another company), the acquirer company must notify the acquired company, in writing, of all acquisitions and divestments in the latter's equity.

In the case of a company that establishes a relationship of control in another company, which is presumed after the acquisition of a majority stake, if the acquirer has more than half of the voting rights or if it has the possibility of appointing more than half of the members of the board of directors or of the supervisory board, the dependent company may not purchase shares of the former company.

Pursuant to the Portuguese Companies Code, if a company acquires 100 per cent of the share capital of another company, a general shareholders' meeting must be convened by the board of directors of the dominant company within six months, to decide whether to dissolve the dependent company, transfer the shares of the dependent company or maintain the existing situation.

Portuguese law also contains squeeze-out and sell-out rules applicable as follows: if a company acquires, directly or indirectly (by means of a company in the same group, or through a dependent company) an interest greater than 90 per cent in another company, the acquiring company must notify the latter of this fact within 30 days of the moment that this amount of interest was achieved. A squeeze-out mechanism is available within six months of the notification, whereby the dominant company may secure the remaining equity from the other shareholders. Similarly, if the dominant company does not squeeze out the remaining shareholders, any minority shareholder may, at any time, demand in writing that the majority shareholder purchases the remaining shares from it, within a time limit of not less than 30 days. In the absence of said purchase, or it being considered unsatisfactory, the minority shareholder may request a judicial purchase from a court of law.

Particularly relevant to private equity investors that do not acquire large interests in their targets, the Portuguese Company Codes ensures, through multiple provisions, that minority shareholders are protected from certain abuses.

First, in public limited liability companies (SAs), although the general shareholders' meeting must be convened according to the law or when any of the boards (board of directors, audit commission, executive management council, audit committee, general and supervisory council) deems it necessary, it will also be convened when one or more shareholders with an interest exceeding 5 per cent requires it. As for private limited liability companies (Ldas), all shareholders may request the managers to convene a general shareholders' meeting or include items in the agenda, and no shareholder may be restricted from participating in the general shareholders' meeting, even if it is prevented from exercising its voting rights.

For a public or private limited liability company to decide on matters such as changes to the company's by-laws, mergers, demergers, transformations or dissolution, a qualified majority is required.

Regarding information rights, public and private limited liability companies operate under different frameworks. Any shareholder of a public limited liability company that holds an interest equal to or greater than 1 per cent of the share capital may, on the basis of justified grounds, consult (1) management reports, accounts, supervisory boards and certified public accountants' reports for the previous three years; (2) convening notices, minutes and attendance lists of the general or special shareholders' meetings or bondholders' meetings for the previous three years; (3) the global remuneration amounts paid to members of the company bodies for the previous three years; (4) the global remuneration amounts paid to the highest-paid employees; and (5) share registry documents. In private limited liability companies, managers must provide true, complete and clear information on the company's management and ensure that inspection of books and documents can be made by any shareholder that so requests it. Although this information right may be further developed in the company's by-laws, its effective exercise may not be prevented or unjustifiably limited in the by-laws.

To prevent abuses by majority shareholders, resolutions approving the non-distribution of profit with the intent to pressure minority shareholders into relinquishing their shares; the increase of share capital with the intention of rendering minority shareholders unable to partake in such an increase; or the change of company headquarters may be annulled if the court finds that the resolution was intended to harm the interests of the company or some of its shareholders.

On the other hand, like majority shareholders, minority shareholders are also subject to the provisions of the Portuguese Companies Code, which may prevent improper conduct such as the abuse of judicial opposition to corporate resolutions with the intent of forcing the company to carry out a transaction that specifically benefits the objector, or even the withholding of votes in favour of a proposed change of the by-laws that is essential to preserving the corporate interests, when those votes are essential for the approval of the relevant resolution.

ii Fiduciary duties and liabilities

Pursuant to the Portuguese Companies Code, directors are subject to fiduciary duties, namely the general duties of care and of loyalty. The duty of care is defined as the standard of a diligent and responsible businessperson and requires directors to have the availability and willingness to carry out the company's management, the proper technical capacity and skills for the performance of the relevant functions and an understanding of the company's business, appropriate for the due performance of the role.

Directors are also bound by a duty of loyalty according to which they must exclusively act in the best interests of the company and of the stakeholders who are relevant for its sustainability, in particular employees, customers and creditors. In addition, the duty of loyalty also comprises three fundamental principles, namely: (1) a non-competition obligation towards the company; (2) a prohibition on taking advantage of corporate opportunities; and (3) a prohibition on trading with the company, except in specific, legally established, situations.

Furthermore, rules set out in the Portuguese Company's Code establish that directors must avoid any activity that can result in a conflict of interest with the company unless express consent has been granted by the general meeting of the shareholders and may not vote on resolutions of the board of directors if they are conflicted in any way (for example, if they are involved in a management buyout). Directors may only enter into agreements with the company in the situations strictly set out in law, may never use the company's assets for their own benefit or the unlawful benefit of third parties and are bound by a duty of confidentiality in respect of information related to the company that is not available to the public.

The duties directors are bound to may be further expanded by means of management agreements and in the by-laws of the company.

Managing entities of private equity funds are subject to specific provisions, established in Law No. 18/2015.[6] The managing entity, in the exercise of its functions, acts on behalf of the investors, independently and in their exclusive interest, with the obligation to perform all acts necessary for a diligent and responsible administration of the private equity fund, according to high levels of integrity, diligence and professional ability. In the performance of its duties, a managing entity shall safeguard the legitimate interests of the investors, refrain from entering into arrangements that may lead to a conflict of interests with investors and set up an organisational structure and internal procedures proportional to the size and complexity of their activity. Apart from being bound to the duties of care and loyalty set out above, directors of managing entities must satisfy demanding fit-and-proper criteria established by the Portuguese Securities Market Commission (CMVM).

In accordance with general principles governing civil liability, any director that wilfully or negligently infringes another person's right, or a legal provision designed to protect the interests of others, is obliged to indemnify the aggrieved party for the damage arising from the infringement. Damage caused to the company, shareholders or third parties may arise from an action or omission in breach of the legal or contractual duties of a director. In respect of damage caused to the company, Portuguese law lays down a rule of fault-based liability, albeit with a presumption of guilt, rather than one of strict liability. Therefore, directors are liable for the damage caused to the company, unless they prove that they did not act with fault. Directors are also liable for damage directly caused to shareholders and third parties to the extent that the aggrieved parties provide evidence of unlawful or negligent conduct on the part of the relevant director that resulted in the damage; furthermore, the director's liability is joint and several with the other directors. Furthermore, directors can be held responsible for damage to creditors of the company, and the applicable rules in this case do not differ

6 Law No. 18/2015 of 4 March 2015, as amended by Decree-Law No. 56/2018 of 9 July 2018, by Decree-Law No. 144/2019 of 23 September 2019, and, more recently, by Decree-Law No. 25/2020, of 7 July 2020, transposed Directives Nos. 2011/61/EU and 2013/14/EU of the European Parliament and of the Council and executed Regulations Nos. 345/2013 and 346/2013 of the European Parliament and of the Council, developing the legal framework applicable to private equity investment activities.

significantly from those regarding damage caused to shareholders and third parties, with the single difference that the aggrieved party bears the burden of proving that the non-payment of the claims is because of the insufficiency of assets of the company and that the insufficiency arises from the director's fault and the breach of the legal provisions designed to protect creditors of the company. The insufficiency of assets alone is not enough to establish the directors' liability.

One or more shareholders holding a minimum share quota of 5 per cent of the company (2 per cent in listed companies) may, in the name and on behalf of the company, file a lawsuit against a director with the intention of receiving compensation for the damage suffered, without prejudice to other lawsuits for compensation in respect of individual damage caused to that same shareholder.

III YEAR IN REVIEW

i Recent deal activity

In 2019, the amount of assets under management registered a notorious increase of €316 million in comparison with 2018, reaching a total of €5.1 billion by the end of the year. Contrary to 2018, this was accompanied by an increase in the value of local private equity investment (of approximately 17.6 per cent).

Turning now to 2020, the year was marked by the exceptional circumstances brought by the covid-19 pandemic, which lead to a reduction in the volume of deals. Despite this impact, there was a relevant increase in deal value, with some exceptional high-value private equity deals in Portugal, including the acquisition by Partners Group from Bridgepoint of a major equity stake in Rovensa (formerly Sapec Agro Business), a leading provider in the agrochemical industry, which was founded and is headquartered in Portugal (with offices in 223 countries). One of 2020's most significant buyouts in the Portuguese private equity sector, the transaction values Rovensa at an enterprise value of around €1 billion.

Considering the uncertainty with regard to the current context, private equity funds focused on the funding needs of their current portfolio, without prejudice of maintaining interest in deals over assets with good performances. There was an increase in the number of funds, both from international general partners targeting the Iberian market and from national players. Nonetheless, the concentration of funds, aligned with difficulties in identifying assets with adequate conditions for investment, may explain why some divesting funds opted to maintain a significant stake in the companies being sold, or even to re-invest with the buyer in such assets, leading to uncommonly high roll-over values.

ii Financing

Private equity transactions are generally carried out with resort to the equity raised by the private equity entity, but also with support in external financing.

Debt financing structures include senior term facilities, senior revolving facilities and mezzanine facilities, which usually require security packages, including pledges over shares, receivables and credit rights under the transaction documents, subject to financial assistance rules.

An important restriction that private equity entities face when resorting to leveraged acquisitions is the prohibition against financial assistance (financing or securing the acquisition of a public limited liability company's own shares). However, there are mechanisms to mitigate the effects of this prohibition, namely the granting of pledges over the target's shares by its shareholders or the tranching of facility agreements to segregate amounts that may be secured by the target company (for example, in respect of working capital requirements) from those that may not (namely, those raised for the acquisition of the target's shares) and resorting to distributions of free reserves or reduction of share capital.

iii Key terms of recent control transactions

Private equity transactions each have their own characteristics, their terms depending on a number of factors, including, but not limited to, the quality and quantity of information disclosed by the seller, the timeline of the transaction taking place and whether due diligence is carried out beforehand.

To mitigate risk, a contractual framework of representations and warranties is usually negotiated between the buyer and seller (more or less robust depending on the profile of the parties, the assurance provided during the due diligence process and the negotiation phase of the transaction) that, if breached, may lead to a number of consequences, typically an indemnity in respect of a claim for damages subject to *de minimis*, thresholds and caps. Contingencies identified in the due diligence process are either addressed as a price reduction or a specific indemnity. In private equity deals, parties tend to resort to warranty and indemnity insurance (generally purchaser insurance) to cover the purchaser against a breach of the representations and warranties, subject to certain limitations, excluding the contingencies known by the purchaser (revealed in the disclosed information) and certain uninsurable matters.

Risk can also be mitigated by means of purchase price structure or adjustment clauses. The most common mechanisms for structuring the purchase price are the locked-box mechanism and a purchase price adjustment based on completion accounts, which are essentially distinguished by the date of transfer of economic risk. With the locked-box system, the valuation of an invested company is based on a historical set of reference accounts (the locked-box accounts), usually dated before the closing of the transaction. This mechanism is the most commonly used in private equity deals and particularly favourable to the seller as there will be no subsequent purchase price adjustment and it results in a swifter, simpler and more cost-friendly deal, as both parties will know the amounts each party has to receive or concede at a specific moment of the transaction. The locked-box system may have variables, namely by setting an interest in favour of the seller to compensate it for the earnings until closing. Recent deals bring more complexity to the locked-box system with 'hybrid' solutions as to the cash produced or date of valuation of the company. Under the completion accounts clause, the definition of the final price is deferred until the moment of the closing of the transaction, with the investor disbursing the purchase price in accordance with the real level of assets and liabilities of the target at closing. The parameters according to which the adjustments of the final value of the purchase price are calculated are usually contractually established in the share sale and purchase agreement.

Conditions precedent are also frequent and standard market practice in almost any private equity transaction, their terms and scope depending on, among other factors, the sector and industry of the target and the need to obtain any regulatory authorisations or third-party waivers or approvals.

As a general standard, the fulfilment of conditions precedent may include both best effort and cooperative obligations. The former determines the amount of effort expected and required of the buyer to satisfy the conditions precedent. The level typically agreed regarding the accomplishment of conditions precedent related to merger control or regulatory authorisations is that of 'commercially reasonable efforts'. On the other hand, cooperative obligations set both parties' mutual duties to cooperate in the attainment of the conditions precedent (e.g., reciprocally providing sensitive information and reviewing filings to regulatory authorities). 'Hell-or-high-water' clauses, imposing upon buyers the obligation to do all that is necessary (as required by the relevant regulatory authorities) to satisfy the conditions precedent, are not common, because of their potential to harm the buyer or the target.

Considering the difficulties in ensuring the investor's willingness to obtain financing for the transaction between the signing and closing, there is usually some reluctance on the part of the seller to include related conditions precedent. Should a special purpose company be incorporated by the buyer to acquire the target shares upon the closing, it is common for the seller to ask for an equity commitment letter to be provided. This letter is only to be effective when the transaction's conditions precedent, as set out in the sale and purchase agreement, are fulfilled.

The exceptional circumstances brought by the covid-19 pandemic were also reflected in the contractual conditions, namely with more complex price structures including some seller financing mechanisms (e.g., deferred purchase price, earn-out mechanisms, among others).

While the legal system in place in Portugal is grounded in civil law, the importance of major common law jurisdictions such as the United Kingdom and the United States in international business has significantly shaped the framework for cross-border deals. Even though Portuguese law governs the overwhelming bulk of transactions involving Portuguese companies, it is within the parties' powers to freely choose a different governing law for the transaction documents. This is more common when one of the parties is a foreign investor. Accordingly, as long as Portuguese law's mandatory rules (such as governing provisions on the transfer of shares, assignment of credits and obligation, among others) are abided by, parties to contracts of either a civil or commercial nature have the right to determine the governing law as provided for in the Rome I Regulation,[7] which is in force in Portugal.

iv Exits

Conversely to 2018, overall divestment experienced a significant decline in 2019, totalling €51.3 million (from €163.4 million in the previous year). In 2019, divestments were in large part made through third-party sales, which amounted to 60.4 per cent of the total divestment in private equity assets and are mainly concentrated in companies in the start-up stage.

Following the trend of previous years, no divestments were made through an initial public offering.

IV REGULATORY DEVELOPMENTS

Pursuant to the Portuguese Securities Code and Law No. 18/2015 (the Legal Framework for Private Equity), prudential and market conduct supervision of private equity entities in Portugal is carried out by the CMVM.[8] As regulator, the CMVM has legislative competencies

7 Regulation (EC) No. 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations.

8 Regarding the supervision of managing entities of private equity investment undertakings, the CMVM may cooperate with the Portuguese Central Bank and the European Securities Market Authority.

and sets out the rules on, but not limited to, asset and debt valuation, accounting organisation, duties of information and fit-and-proper requirements of the members of the corporate bodies and holders of qualified shareholdings of and in private equity entities.[9]

With the introduction of the Legal Framework for Private Equity, private equity entities may be subject to one of two legal regimes, depending on the value of their assets under management. If the asset value under management of a private equity entity is greater than €100 million (in respect of portfolios containing assets acquired with recourse to leverage) or €500 million (in respect of portfolios not containing assets acquired with recourse to leverage and in respect of which there are no redemption rights for an initial five-year period), private equity entities are considered to be above a relevant, legally established threshold, and are subject to a more demanding legal framework than entities that do not have assets under management that cross any of these two thresholds. Private equity entities that fall under the more demanding framework are subject to, among other things, the following rights and obligations:

a the prior authorisation of the regulator for their incorporation;
b the EU passporting system for banks and financial services applicable to the private equity fund participation units concerned;
c disclosure to the regulator of outsourcing of management and other services; and
d a requirement for the implementation and maintenance of conflict-of-interest policies to avoid, identify and manage potential conflicts.

In 2018, Decree-Law No. 56/2018 of 9 July 2018 amended the Legal Framework for Private Equity. Among other changes, the Decree-Law (1) removed the 10-year time limit on the qualification of private equity investments, allowing private equity companies and funds to manage their portfolio in a more flexible way; (2) introduced further clarification of the calculation methodology to be followed to determine the legal framework applicable to private equity entities; and (3) extended the scope of private equity investments aimed at promoting social entrepreneurship to include entities other than companies, such as associations and foundations.

In 2019, Decree-Law No. 144/2019 of 23 September 2019 also amended the Legal Framework for Private Equity, which provides for the transfer to the CMVM of the powers and competences relating to the prudential supervision of investment fund management companies and securitisation fund management companies, which was previously carried out by the Bank of Portugal. This legal act incorporated credit funds (loan funds) in the Portuguese legal system and qualified them as specialised alternative investment schemes of credit, with a view to fostering the capital market and diversifying companies' sources of funding, providing financing. These funds are committed to financing the economy directly through the granting of credit to companies and indirectly through the acquisition of credits, including non-performing loans held by banks. Notwithstanding, these funds are not allowed to carry out certain operations, such as short sales of securities; securities financing transactions, including securities lending; or derivatives, except for the purpose of risk coverage. Additionally, these funds are not allowed to lend money to natural persons or financial institutions.

9 CMVM Regulations Nos. 3/2015 (as amended by Regulations Nos. 5/2020 and 6/2020) and 12/2005.

In 2020, the Legal Framework for Private Equity was once again amended by Law No. 25/2020, of 7 July 2020, which introduced slight adjustments to the terms and conditions of the administrative offences foreseen for the breach of the obligations set out in this legal regime.

Furthermore, within the scope of its legislative competencies, the CMVM has recently enacted new regulations, among which we can highlight: (1) CMVM Regulation No. 1/2020, defining the form and content of the transparency obligations of collective investment scheme management companies and credit securitisation fund management companies, to inform the CMVM on a quarterly basis of their economic and financial situation; as well as (2) CMVM Regulation No. 5/2020, which amends CMVM Regulation No. 3/2015 to set up the legal framework applicable to loan funds, as provided for in Decree-Law No. 144/2019, of 23 September 2019.

In light of the covid-19 pandemic, the Development Finance Institution has also approved solutions aimed at facilitating the execution of financing operations through private equity funds[10] (e.g., until 31 December 2020, private equity funds were entitled to carry out investment rounds without the mandatory entry of new independent investors).

V OUTLOOK

By the end of 2019, following the developments of private equity investment registered in Europe, the total amount of assets under management in the private equity sector maintained the growth trend of previous years.

However, although turnaround transactions still represented the majority of private equity deals in Portugal in 2019, there has been a continued decrease in this type of transaction, replaced by a trend for growth investment and management buyouts. This rebalancing of private equity, undertaken by more speculative participants through more conservative transactions, indicates that the market has matured and traditional investors are becoming more confident in the domestic business fabric.

While it is likely that this trend of systematic growth will no longer be experienced in 2020, there are several factors that can lead the sector to a swift recovery, reinstating 'pre-pandemic' standards.

For one, the Portuguese state has been making significant efforts to protect the economy from a potential recession, enacting remedies aimed at mitigating the economic impacts of this exceptional situation (e.g., credit lines and subsidies). Such solutions will also be complemented by an exceptional stimulus package from the European Union.

Besides this, the increased adaption of companies to this 'new normal', and the emergence of new sectors of activities can open the door to new investment opportunities. Other aspects, such as new private equity firms becoming active in the domestic market, continued appetite of global private equity firms in the Iberian and Portuguese markets, political and regulatory stability, low interest rates, an increase in financial fund willingness to invest in certain transactions may also prove crucial for the development of the private equity sector in Portugal in the coming years. In fact, it is possible that we assist to a recovery in deal volume in the post pandemic context, including transactions that started to be prepared

10 www.ifd.pt/pt/medidas-de-flexibilizacao/.

last year but were delayed because of the unfavourable economic environment caused by the covid-19 pandemic, as well as some opportunities for distressed investments in companies that had a worse performance during this period.

Chapter 11

SOUTH KOREA

Chris Chang-Hyun Song, Tong-Gun Lee, Brandon Ryu, Tom Henderson and Dong Il Shin[1]

I OVERVIEW

i Deal activity[2]

In recent years, growth in the South Korean M&A market has been driven by both domestic and cross-border M&A transactions. This trend has continued throughout 2020. Although the expansion of the South Korean M&A market has been dampened somewhat by the covid-19 pandemic in 2020, domestic transactions have taken place at a similar level as in 2019, and the value of outbound transactions has actually increased compared with the previous year. This demonstrates the continued importance of outbound M&A transactions to South Korean companies and private equity sponsors.

The volume of outbound M&A transactions in 2019 was at a similar level as in 2018 with 80 total transactions. The combined value of all outbound M&A transactions in 2019 was US$15.57 billion. There was an increase in the volume of inbound transactions in 2019 by 4.2 per cent compared with 2018, with 50 total transactions, and a value increase of 46.5 per cent to US$14.5 billion. A small reduction of 1.7 per cent was recorded for 2019 domestic transactions compared to 2018, with 405 total transactions for a total value of US$45.5 billion, representing an increase of 8.5 per cent. The key takeaway is that, like in 2018, while domestic M&A transactions in 2019 continued to account for the largest slice of the M&A market in South Korea for now, cross-border M&A transactions are on the rise.

The number of outbound M&A transactions fell in 2020 to 56 transactions from 80 in 2019, but the value of 2020's transactions has increased by 18.1 per cent to US$17.2 billion. Inbound M&A transaction volumes have reduced by 42 per cent year on year to 29 total transactions, with a corresponding decrease in overall transaction value of 66.9 per cent to US$4.8 billion. While domestic M&A transaction volume dropped by 11.3 per cent to 362 transactions compared with 2019, overall value remained approximately the same at US$39.6 billion, a 0.1 per cent reduction.

In 2019, there was a total volume of 456 M&A transactions, with a total deal value of US$60 billion. This represents the highest recorded volume of transactions, with overall value constituting an increase on 2018 of 13.8 per cent. There were several noteworthy

1 Chris Chang-Hyun Song and Tong-Gun Lee are partners, Brandon Ryu is a senior foreign attorney, Dong Il Shin is an associate and Tom Henderson is a foreign attorney at Shin & Kim LLC.

2 All statistics on the value and volume of M&A deals in Korea involving private equity funds were retrieved from Mergermarket. They are based on M&A deals announced for the given year (the announcement is based on the signing date), some of which have not disclosed the size of investment; the statistics take into account only direct investments by private equity funds and not those done through special purpose vehicles.

cross-border transactions in 2019, including SKC's sale of its chemical division to Kuwait's state-owned PIC for a total of US$442 million, as well as IMM Private Equity's acquisition of Linde Korea from Linde AG for a total of US$1.17 billion. On the domestic side, Korea Shipbuilding & Offshore Engineering's acquisition of Daewoo Shipbuilding & Marine Engineering for US$4.5 billion is considered one of the most notable transactions of 2019.

The Korean outbound M&A transaction space continues to draw attention in 2020, with transactions of note including SK Hynix's acquisition of Intel's NAND memory and storage business valued at US$9 billion, Hyundai Motor Group's acquisition of an 80 per cent stake in US robotics and mobility company Boston Dynamics for US$880 million, and MBK Partners' strategic takeover of Chinese rental car company Car Inc through a purchase of the remaining 20.86 per cent of Car Inc's total issued shares for US$2.175 billion. Substantial domestic transactions include Korean Air's acquisition of a 63.88 per cent stake in Asiana Airlines for US$8.358 billion, KB Financial Group's acquisition of Prudential Life Insurance for US$1.949 billion, and Baring Private Equity and Affinity Private Equity's joint purchase of 7.33 per cent of the total shareholding of Shinhan Financial Group for US$974 million.

Overview of private equity fund activity

Offshore private equity funds (foreign PEFs) became active in Korea during the immediate aftermath of the Asian financial crisis of 1997. They were followed by the emergence of onshore private equity funds (Korean PEFs) a decade later, with the introduction of the Financial Investment Services and Capital Markets Act (FSCMA) in 2007. Currently, all aspects of PEF activities, ranging from fundraising and investment to exits, demonstrate that PEFs have a robust presence in Korea that is continuing to grow. The current administration is also seeking to alleviate regulatory burden of PEF registration and investment requirements by amending the FSCMA, and a significant amount of fresh, policy-driven capital in the form of the Growth Ladder Fund as well as the Corporate Structure Innovation Fund promises to further fuel PEF activities. Based on these factors, the growth trend of PEF activity in South Korea is expected to continue in the coming years.

In 2020, there were 90 acquisition deals sponsored by PEFs worth US$11.9 billion in value, and 45 exit deals by PEFs worth US$6.74 billion. The table below shows the annual aggregate deal volume and deal count for acquisitions and exits by PEFs in 2019 and 2020, as compared with 2007.

	Acquisitions		Exits (excluding IPOs)	
Year	Deal value (US$ billion)	Deal volume	Deal value (US$ billion)	Deal volume
2020	11.9	90	6.74	45
2019	15	111	13.3	37
2007	4.86	13	4.33	17

A breakdown of PEF-driven acquisitions by transaction volume according to price bracket shows that in 2019 there were 26 acquisitions in the US$100 million to US$500 million range, accounting for 76.5 per cent of all PEF-driven acquisitions; five acquisitions in the US$500 million to US$1 billion range, reflecting 14.7 per cent of all PEF-driven acquisitions; and three acquisitions at or above US$1 billion, thus accounting for 8.8 per cent of all PEF-driven acquisitions. In 2020, there were 28 acquisitions in the US$100 million to

US$500 million range, accounting for 82.4 per cent of all PEF-driven acquisitions; and six acquisitions in the US$500 million to US$1 billion range, reflecting 17.6 per cent of all PEF-driven acquisitions.

As for PEF-driven exits (excluding IPOs) by transaction number in 2019, there were 14 exits in the US$100 million to US$500 million range, accounting for 70 per cent of all PEF-driven exits, three exits in the US$500 million to US$1 billion range, accounting for 15 per cent of the total PEF-driven exits, and three exits at or above the US$1 billion mark, accounting for a further 15 per cent of all PEF-driven exits. In 2020, there were 12 exits in the US$100 million to US$500 million range, accounting for 75 per cent of all PEF-driven exits, three exits in the US$500 million to US$1 billion range, accounting for 18.8 per cent of all PEF-driven exits, and one exit at or above the US$1 billion mark, accounting for 6.3 per cent of all PEF-driven exits.

PE fund acquisition trends

Buyout, majority stake and minority stake deals slightly decreased in 2020 compared with 2019 in terms of deal value and deal volume. Buyout transactions in 2020 decreased by 18.7 per cent in deal value compared with 2019, while the deal value of majority stake and minority stake deals remained at a similar level. In terms of deal volume, buyouts actually increased by three transactions, while majority stake and minority deals decreased by 22.8 per cent and 45.4 per cent, respectively. Much like in 2019, buyout and majority stake deals constituted the majority of total transaction value for 2020. The value of buyout deals suffered from the largest decline in value, resulting in minority stake deals occupying a larger proportion of overall value in 2020, with 17.3 per cent (compared with the 16.4 per cent that minority stake deals held in 2019).

Year	Buyout (100%)		Majority stake (50% or more)		Minority stake (up to 50%)		Undisclosed	
	Deal value (US$ billion)	Deal volume	Deal value (US$ billion)	Deal volume	Deal value (US$ billion)	Deal volume	Deal value (US$ billion)	Deal volume
2020	5.76	54	4.74	27	2.21	12	—	—
2019	7.09	51	5.44	35	2.46	22	—	—
2007	0.21	3	1.91	1	2.73	9	—	—

PE fund exit trends

Trade sales have traditionally been the main exit channel for PEFs. However, secondary sale exits are becoming more common, and in 2020, approximately 29 per cent of all PE fund exits took place as secondary sales. There was a decrease of IPO exits in 2020 compared with 2019, and as in previous years, IPO exits did not constitute a significant exit channel in 2020 compared to trade sales and secondary sales.

Year	Trade sales		Secondary sales		IPO	
	Deal value (US$ billion)	Deal volume	Deal value (US$ billion)	Deal volume	Deal value (US$ billion)	Deal volume
2020	4.72	27	2.02	18	0.12	2
2019	10.7	23	2.63	14	0.85	15
2007	3.07	11	1.24	4	0.08	2

Trend of public-to-private transactions

There were no public-to-private deals in 2018, 2019 and 2020, with a single public-to-private transaction worth US$360 million recorded in 2017. In general, public-to-private deals are not common in Korea, with only four public-to-private transactions recorded from 2007 to 2020.

Registered private equity funds

As at September 2020, a total of 797 PEFs were registered with the Financial Supervisory Service (FSS).[3] In 2019, there were 206 newly registered PEFs, which is a similar number as 2018. Despite the total number of newly registered PEFs being higher in 2019, the actual combined value of capital invested in these PEFs (i.e., the total commitment amount) of 15.6 trillion won is 0.8 trillion won lower than the equivalent figure of 16.4 trillion won from 2018. This indicates there were a substantial number of PEFs registered to participate in smaller-sized deals. The total commitment amount increased from 83.4 trillion won in 2019 to 92.1 trillion won in the first three quarters of 2020.

Year	2020	2019	2018	2017	2015
Newly registered PEFs	136	206	198	135	76

Registered general partners of private equity funds

As at December 2019, a total of 304 general partners (GPs) were registered with the FSS, 210 of which being full-time GPs. The remaining 94 GPs are comprised of existing financial institutions, start-up investment companies and new technology companies. This constitutes an increase in overall GP registration compared with 2018 of 50 registrations, 42 of which being full-time GPs. Full-time GPs account for 69.1 per cent of all newly registered GPs (66.1 per cent in the case of 2018), which shows an increase in the proportion of full-time GPs.

Year	2019	2018	2017	2015
Full-time GPs	210	170	138	94
Financial institution GPs	38	37	35	41
Start-up GPs	56	49	36	32
Total GPs	304	256	209	167
Newly registered GPs	50	15	19	5
Newly registered full-time GPs	42	32	23	12

The largest private equity funds set up by major GPs in Korea in terms of committed capital are as follows: a 3.018 trillion won fund set up by MBK Partners called MBK V; a 2.540 trillion won fund set up by MBK Partners called MBK III; a 1.827 trillion won fund set up by Hahn & Company called Hahn & Company III-1; and a 1.581 trillion won fund set up by IMM Private Equity called IMM Rose Gold IV.

3 The vast majority of these were registered under the FSCMA, but the total number includes those registered under the Industrial Development Act and the Overseas Resources Development Business Act, *Financial Supervisory Service, Status of Private Equity Funds in September 2019* (30 September 2019).

ii Operation of the market

Market-standard management equity incentive arrangements

There are certain precedents wherein a PEF with a controlling stake grants stock options or a small percentage of shares (either through transfer or issuance of new shares) to management with the aim of aligning the interests of the PEF with management. However, sophisticated forms of management equity incentive arrangements remain relatively uncommon in South Korea.

Standard sales process

As is the case in other jurisdictions, the investment process for private equity funds in South Korea usually takes place across the following stages: (1) deal structuring; (2) due diligence checks of investment target; (3) negotiation of deal terms; and (4) closing. In a standard share purchase transaction, the parties would first determine a due diligence cut-off date or valuation date, followed by the buyer conducting due diligence on the target. After due diligence, the parties would negotiate the terms and execute a share purchase agreement reflecting such terms. Subject to the fulfilment of conditions precedent to the closing date, the buyer would pay the purchase price to the seller and the seller would transfer its shares to the buyer. The final step usually involves a shareholders' meeting or a board meeting to effect the replacement of the existing directors and officers of the target.

The overall process can take around six to seven months on average. However, this timeline can vary depending on the particular nature and complexity of each deal. If regulatory authorisations are required to complete the deal (e.g., because of foreign capital investment, industry-specific licensing requirements, or market dominance or competition-related issues), the process can be further delayed. Generally, these regulatory authorisations are not especially onerous or far-reaching in terms of scope and depth of regulatory review, and are therefore not considered significant obstacles in most South Korean M&A deals.

II LEGAL FRAMEWORK

i Acquisition of control and minority interests

Pursuant to the FSCMA, Korean PEFs are required to either acquire de facto control over the target company or otherwise acquire a minimum of 10 per cent or more of the target company's voting shares. Because of these regulatory restrictions, Korean PEFs must either engage in a buyout, acquire a majority stake in the target company, or otherwise acquire a minority stake of 10 per cent or higher. If a Korean PEF acquires a minority stake in a company, it can still influence the management or governance of the target company by means of a shareholders' agreement with the controlling shareholder or major shareholders.

Unlike Korean PEFs, foreign PEFs are not subject to these regulatory restrictions under the FSCMA, and thus Korean PEFs have been pressing for regulatory change to secure a level playing field between Korean PEFs and foreign PEFs.

ii Fiduciary duties and liabilities

Subject of fiduciary duties

The Korean Commercial Code does not impose fiduciary duties on a shareholder towards the company. Furthermore, a shareholder is not liable for the debts of the company aside from the shareholder's investment contribution.[4] Therefore, a PEF (or its GP) shareholder does not owe any fiduciary duty towards the company and is not liable for the company's debts beyond its investment contribution.

Directors do owe fiduciary duties towards the company under the Korean Commercial Code (KCC) and can be held both civilly and criminally liable for actions that result in harm to the company. These fiduciary duties and liabilities apply to all directors of the company, whether inside or outside directors, as well as to non-executive directors. Furthermore, individuals who do not officially hold director titles but nonetheless exert control over the company's management can be treated as 'de facto directors' pursuant to the KCC and will be subject to the same fiduciary duties and liabilities as directors. It is common practice for personnel from a PEF investor to serve on the board of directors of a target company. Therefore, by extension, the PEF-nominated director would also be subject to fiduciary duties and liabilities to the target company.

Fiduciary duties in leveraged buyout transactions

Another point of note regarding fiduciary duties concerns leveraged buyout transactions (LBOs). Currently, there are differing opinions as to whether company directors can be held civilly and criminally liable for LBOs. The court precedents from the Korean judiciary distinguish between 'collateralised LBOs' and 'merger LBOs'. In relation to the former, where the target company's assets are used as collateral to obtain acquisition financing without giving any benefit to a target company, the Korean courts have ruled that the directors responsible are in criminal breach of their fiduciary duties. In contrast, in merger-LBO scenarios, where the acquiring party sets up a special purpose company (SPC) and merges the target company with the SPC (thereby having the target company succeed to the liabilities of the SPC), the South Korean courts have not found any criminal breach of fiduciary duties by the directors involved in debt push-down mergers of this type, as long as the merger ratio is reasonably set and the merger procedures are taken in accordance with statutory requirements. Note, however, that these court rulings do not necessarily imply a bright-line rule with regard to criminal breach of fiduciary duties in an LBO context; for each transaction, the courts will decide based on the totality of circumstances (e.g., whether the LBO will enhance managerial efficiency, financial conditions and company value).

Korean courts will consider the factual matrix to determine whether any particular LBO constitutes a collateralised LBO or a merger LBO, and whether directors of a target have complied with their fiduciary duties will depend on this distinction. In October 2020, in a case concerning potential fiduciary breaches in the LBO of Himart, an electronics distribution company, the Korean Supreme Court found that the Seoul High Court's

4 As an exception, a majority shareholder holding 51 per cent or more of a company's total issued shares can be subject to secondary tax liability. Additionally, the court may pierce the corporate veil in rare cases when the corporate entity is only used for avoidance of shareholder's debt or liability, in which case the shareholder will also be subject to liability with regard to the company.

interpretation of the factual matrix was incorrect.[5] The Seoul High Court had held that the transaction constituted a merger LBO, and accordingly the directors of Himart had not breached their fiduciary duties. The Korean Supreme Court overruled this judgment to find that the transaction was in fact a collateralised LBO, after considering factors such as the transaction agreement and the fact that the purchaser of Himart intended to use Himart's assets as collateral for its acquisition financing.[6] The Korean Supreme Court accordingly found the Himart directors guilty of breach of fiduciary duty. Prospective investors must therefore be aware of the potential liability of target company directors resulting from M&A transactions that utilise LBOs.

III YEAR IN REVIEW

i Recent deal activity

The year 2020 saw a diverse range of M&A deals in South Korea in terms of deal size, ranging from small and medium-sized deals to mega deals worth US$1 billion and above. SK Hynix's acquired Intel's NAND memory and storage business for US$9 billion in one such mega-sized, cross-border acquisition deal. Hyundai Motor Group's acquisition of an 80 per cent stake in US robotics and mobility company Boston Dynamics for US$880 million represented another significant cross-border deal.

Noteworthy domestic M&A transactions include Korean Air's acquisition of a 63.88 per cent stake in Asiana Airlines for US$8.358 billion, KB Financial Group's acquisition of Prudential Life Insurance for US$1.949 billion, and GS Energy's acquisition of a 50 per cent stake holding in GS Power for US$1.598 billion.

Notable past transactions

Notable M&A deals led by PEFs in recent years are as follows.

In September 2020, Baring Private Equity and Affinity Private Equity acquired 7.33 per cent stake in Shinhan Financial Group, with a deal value of approximately US$970 million.

In April 2019, IMM Private Equity acquired a 100 per cent stake in Linde Korea, with a deal value of approximately US$1.17 billion.

In February 2017, MBK Partners acquired a 100 per cent stake in DaeSung Industrial Gases, with a deal value of approximately US$1.5 billion.

In December 2016, the consortium of Hanhwa Life Insurance, Korea Investment & Securities, TongYang Life Insurance, Kiwoom Securities, Mirae Asset Global Investment, IMM Private Equity and Eugene Asset Management acquired a 29.7 per cent stake in Woori Bank, the fourth-largest commercial bank in Korea, with a deal value exceeding US$2 billion.

In September 2015, the consortium of Temasek Holdings, Canada Pension Plan Investment Board, MBK Partners, Public Sector Pension Investment Board and Chengdong Investment acquired a 100 per cent stake in Homeplus, a large hypermarket store chain, from Tesco, with a deal value of approximately US$6.4 billion.

The above shows a trend of PEFs participating in large M&A deals as co-investors or consortium partners.

5 Seoul High Court decision on 24 July 2016, case number 15No478 (S. Kor.).

6 Korean Supreme Court decision on 15 October 2020, case number 16Do10654 (S. Kor.).

ii Financing

As mentioned in Section II.ii, there is uncertainty as to whether obtaining acquisition financing through LBOs constitutes a breach of directors' fiduciary duties. Because of this restriction on LBOs, PEFs in South Korea tend to raise acquisition financing through loans from financial institutions. The amount and terms of such loans are determined based on the financial health and business operations of the target company. If a target company holds existing liabilities, it is market practice for PEFs to have the target company pay off the existing liabilities through refinancing from the financial institution simultaneously with the completion of the acquisition of the target company by PEFs. In large M&A deals, a syndicate of financial institutions provides loans often consisting of term loans and revolving facilities. Though it is not common, vendor financing has been provided in some M&A deals.

iii Key terms of recent control transactions

Closing certainty and clean-exit mechanisms

In acquisition transactions, certainty of closing and break-up (termination) flexibility are key concerns for PEFs, so they tend to request strict representations and warranties, indemnification obligations and material-adverse-change (MAC) clauses from the seller, while objecting to contractual language that undermines closing certainty or restricts their break-up flexibility. In recent years, insolvent companies have started to comprise a significant portion of M&A targets in Korea. Because sales and purchases of insolvent companies are supervised by the courts, the courts will sometimes impose various restrictions or conditions, such as purchase price adjustment restrictions and MAC clause prohibitions, from the onset of the bid process.

The 2020 covid-19 pandemic prompted interest in interpretation of definitions of MAC clauses in M&A agreements. Sellers are incentivised to reducing the scope of a MAC clause to the greatest extent possible to ensure closing certainty and push for covid-19-related matters to be explicitly carved out from the definition of a MAC. Contrastingly, purchasers attempt to expand MAC definitions as broadly as possible and include the occurrence of a MAC as a ground to terminate the agreement. A relevant dispute involved the aborted acquisition of Asiana Airlines by HDC Hyundai Development, because of the financial deterioration of Asiana Airlines caused by business-environment and economic changes in the aftermath of the covid-19 pandemic. The parties are currently engaged in a dispute in the Korean court as to whether Asiana Airlines' financial deterioration constituted a MAC entitling termination of the agreement. There are few historical instances of Korean courts enforcing MAC clauses, and prospective investors would be wise to monitor the development of this case as to whether Korean courts are agreeable to covid-19-induced financial distress entitling cancellation under MAC clauses.

Additionally, with the rising popularity of representations and warranties insurance, an increasing number of transaction documents include provisions to the effect that damages incurred as a result of a breach of representations and warranties shall be handled by the coverage amount of the relevant representations and warranties insurance policy. The use of representations and warranties insurance is increasing among PEFs, who require a clean exit when divesting portfolio companies that transfers all liability for damages away from the seller. This is also increasingly common in tender sales, which are often used for large-scale M&A deals, as bidders can enhance their bids by including in their offer a representations and warranties insurance policy that guarantees the seller a clean exit.

Purchase price adjustment mechanisms

Purchase price adjustment mechanisms are fairly common in Korea, with the following options available: (1) a price adjustment mechanism based on net working capital, whereby the risk of value fluctuation between the valuation date and the closing date is borne by the seller;[7] (2) the 'locked-box' method, whereby the risk of value fluctuation between the valuation date and the closing date is borne by the buyer; [8] and (3) the earn-out method, whereby the buyer potentially pays an additional purchase price amount based on the target company's earnings before interest, tax, depreciation and amortisation, business profits, net profits, cash flow, turnover, etc.[9] In South Korea, it is common for parties to either opt for the locked-box method or forgo a purchase price adjustment mechanism altogether.

Confidentiality

Before proceeding with a transaction, it is usual practice for PEFs to impose confidentiality obligations on the counterparties with regard to the transaction by way of a non-disclosure agreement. Such confidentiality obligations are particularly important with regard to publicly listed companies, as news of a potential acquisition may have a substantial effect on share prices and, by extension, result in a higher acquisition price. A related issue is that publicly listed companies may have limited capacity to enter into confidentiality obligations because of disclosure requirements. When faced with a disclosure request from the Korea Exchange, parties sometimes opt to disclose that a potential acquisition is being contemplated.

iv Exits

Recent notable exits

The joint sale of Oriental Brewery by KKR and Affinity Equity Partners with a deal value of approximately US$6.2 billion was both the largest and the most highly publicised exit by a PEF in Korea. In 2019, KKR successfully exited by selling 100 per cent of its shares in KCF Technologies to SKC for approximately US$1.02 billion. The 2012 sale by Lone Star of its 51.02 per cent stake in Korea Exchange Bank with a deal value of approximately US$3.4 billion remains the second-largest private equity fund exit transaction in Korea. In 2018, the Carlyle Group sold its 100 per cent stake in Siren Holdings, a company engaged in security solutions through its subsidiary ADT Caps, to a consortium of SK Telecom, Daishin PE and Keistone Partners with a value of approximately US$2.7 billion. In 2017, Goldman Sachs and Bain Capital sold a 95.39 per cent stake in Carver Korea, a cosmetic manufacturer, to Unilever, with a value of approximately US$2.5 billion.

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7 A potential downside of this option is that the parties have to come to an agreement on which accounts should be included to determine net working capital.

8 Under this option, the buyer will pay interest on the purchase price accumulated from the locked-box date up until the closing date, provided, however, that the transaction document clearly states that certain leakage from the target company is prohibited, and if leakage should occur, the buyer shall be indemnified accordingly.

9 The earn-out period is usually set at two to three years; a potential downside is that the buyer must continue to closely monitor the operations and earnings of the target company during this period.

Drag-along rights

PEFs divesting investments through the exercise of drag-along rights to compel other shareholders to sell all shares in a company is fairly common practice. The usage of drag-along rights was put under the spotlight by the Korean Supreme Court in January 2021.[10] In that case, IMM and a number of other investors purchased shares in Doosan Infracore China Corporation (DICC). The investors entered into a shareholders' agreement with Doosan Infracore (Doosan), the largest shareholder of DICC, which provided that if DICC did not complete an IPO within a specified period, the investors would be entitled to exercise a drag-along right against Doosan. This drag-along provision contained an option that Doosan may opt to purchase all shares of the company at the same price as offered by a third party rather than being forced to sell.

DICC failed to complete an IPO within the required time period, and the investors exercised their drag-along right. However, Doosan and DICC did not cooperate with the investors in the drag-along sales process including due diligence, claiming confidentiality concerns prevented them from disclosing this information until a certain buyer was located. As a result, all prospective purchases declined to commit to a purchase of DICC. The investors asserted (1) this constituted a breach of the Doosan's obligation to act in good faith; (2) Doosan was therefore deemed to have exercised its option to purchase the investors' shares at the price offered by the highest prospective purchaser; and (3) a corresponding sale and purchase agreement between Doosan and the investors was deemed to exist. The investors demanded payment of the sale price for their shares pursuant to the purported sale and purchase agreement.

The Korean Supreme Court ruled in favour of Doosan and held that in order for an agreement to be deemed to exist pursuant to the drag-along clause, the initial prospective purchaser needed to have been specified at the time of exercise of the drag-along right, and that the investors had no right to compel Doosan to purchase their shares.

This demonstrates the importance of setting out in clear language the procedure for exercise of a drag-along right, and expressly stating that both parties must do all things necessary to procure successful completion of the drag-along transaction. The parties must also clearly state the penalties for non-cooperation. Failure to include this clear language may result in a drag-along right being legally or practically unenforceable in Korea.

IV REGULATORY DEVELOPMENTS

i Regulatory landscape

Following the entry of foreign PEFs into the South Korean M&A market, the South Korean legislature went on to provide a legal framework for onshore private equity funds (Korean PEFs) by implementing the Indirect Investment Asset Management Business Act of 2004 and its successor, the FSCMA. The FSCMA requires all Korean PEFs to be registered with the FSS. Furthermore, as stated in Section II.i, Korean PEFs are required either to acquire de facto control over the target company or otherwise acquire a minimum of 10 per cent or more of the target company's voting shares, whether directly or through an SPC.

10 Korea Supreme Court decision on 14 January 2021, case number 18Da223054 (S. Kor.)

There is no general legal framework that governs PEF M&A transactions. Similarly, M&A transactions by PEFs are not subject to approval by a designated regulatory body. Nonetheless, each transaction can have differing regulatory requirements depending on the nature of the target company's business and industry.

ii Recent regulatory measures

On 27 September 2018, the FSS announced its plans to reform the regulations governing PEFs and hedge funds. While these measures are still at the discussion stage, it is anticipated that reform of PEF regulations will have a positive impact on the legal framework for PEFs, and will facilitate investment activity by PEFs within the Korean market. Specifically, the FSS is seeking to implement the following: (1) removal of the minimum 10 per cent stake rule that currently governs PEFs; (2) removal of the distinction between PEFs and hedge funds, with both instead being re-categorised as general PEFs (PEFs that raise financing from retail, professional and institutional investors) and institutional PEFs (PEFs that raise financing exclusively from institutional investors), pursuant to which only institutional PEFs with the capacity to supervise their GPs will be permitted to make investments as limited partners; and (3) permitting PEFs to have up to 100 investors, an increase to the current limit of 49 investors.

The M&A landscape in 2021 will depend on the regulatory reform efforts of the South Korean government and geopolitical factors such as South Korea's relationship with neighbouring countries and the denuclearisation of North Korea.

V OUTLOOK

The South Korean M&A market has seen varying degrees of ups and downs in the past few years. Nonetheless, the South Korean M&A market continues to show resilient deal making and continued growth. Despite the covid-19 pandemic's substantial impact on the M&A market in 2020, positive factors such as the upward trend of the government's pro-M&A regulatory stance, various pre-emptive restructuring attempts by South Korean companies, and the ongoing development of PEFs have helped to create cautious optimism that the M&A market will continue to remain robust in 2021.

In terms of challenges in 2021, PEFs will have to grapple with the ever-changing economic situation in South Korea, as well as with competition from strategic investors. Uncertainties arising from the covid-19 pandemic and the related social and economic disruption and the ongoing trade war between the United States and China are also projected to impact South Korea's M&A market in 2021. Nonetheless, the positive factors noted above may offset these negative influences, and considering the financial constraints of corporate and strategic investors at this juncture, there is significant dealmaking potential for both domestic and foreign PEFs in 2021.

Chapter 12

SWITZERLAND

Phidias Ferrari, Vaïk Müller and Pierre-Yves Vuagniaux[1]

I OVERVIEW

i Deal activity

Private equity (PE) transactions in the Swiss market comprise the full spectrum in terms of structures and strategies, including on the investment side, venture capital, growth capital, replacement capital and buyouts (in the form of acquisition of controlling or minority equity interests, club deals or joint ventures with strategic buyers), and on the divestment side, trade sales, secondary sales and initial public offerings (IPOs).

Over recent years, private equity (PE) activity in Switzerland continued to be strong, driven by low or negative interest rates, affordable acquisition financing, intense fundraising by PE funds resulting in a high amount of dry powder and the attractiveness of the Swiss innovation sector with a dynamic venture capital ecosystem.[2] In 2020, private equity investments in Swiss startup portfolio companies slightly declined relative to previous years but overall remained high, at around 2.1 billion Swiss francs (compared to approximately 2.2 billion Swiss francs in 2019).[3] Technology, media and telecommunications (TMT), pharma, biotech and healthcare are among the key industries for PE investments in Switzerland, with buy-and-build strategies being increasingly pursued. The Swiss market is also characterised by its international dimension, with foreign PE funds being involved in the majority of the transactions, especially in the small and mid-cap market.[4]

Because of the covid-19 pandemic, deal flows in Switzerland declined in the first half of 2020, down by approximately 25 per cent compared to the first half of 2019, with a number of transactions having being postponed or suspended. However, market studies show that PE investments remained an essential driver of M&A activity, especially in relation to Swiss small and medium enterprises (SMEs).[5] During the first half of 2020, PE firms continued to be active as financial investors acting as buyers or sellers were involved in around 40 per cent of the deals.[6]

1 Phidias Ferrari is a partner, Vaïk Müller is a senior associate and Pierre-Yves Vuagniaux is a partner at Tavernier Tschanz.

2 Switzerland was ranked among the top positions by the Global Innovation Index 2020: www.wipo.int/global_innovation_index/en/2020/.

3 Swiss Venture Capital Report 2021, p. 7.

4 www2.deloitte.com/content/dam/Deloitte/ch/Documents/mergers-acqisitions/deloitte-ch-en-mid-cap-2020.pdf (page 6).

5 www2.deloitte.com/content/dam/Deloitte/ch/Documents/mergers-acqisitions/deloitte-ch-en-mid-cap-2020.pdf (page 20).

6 https://home.kpmg/ch/en/home/media/press-releases/2020/07/damper-on-ma-business.html.

In recent years, Switzerland was considered a seller's market for PE transactions with significantly more investments than divestments, high valuations and more seller-friendly terms. It remains to be seen whether this trend will continue amid the global covid-19 pandemic and related uncertainties (especially in terms of access to acquisition financing). Some expect to see an increase in distressed and restructuring transactions (including carve-outs), while others are confident that PE activity in Switzerland will remain steady as the economic environment may generate investment opportunities with lower company valuations and numerous SMEs have to plan for succession.

Recent notable PE deals include the following:

a the sale of Nestlé Skin Health by Nestlé SA to a consortium led by EQT Partners and Abu Dhabi Investment Authority (2019; US$10.2 billion);

b the sale of gategroup Holding AG by HNA Group Co, Ltd to RRJ Capital (2019; US$2.8 billion);

c the sale of Parex Group SA by CVC Capital Partners to Sika AG (2019; over US$2.5 billion);

d the sale of Tertianum Group by Swiss Prime Site to Swiss PE firm Capvis (2019; amount undisclosed);

e the US$484 million series E financing round in GetYourGuide AG led by SoftBank Vision Fund (2019);

f the US$110 million series F financing round in Sophia Genetics SA led by health-tech and life sciences venture fund aMoon and Hitachi Ventures (2020);

g the US$110 million equity investment in Climeworks AG (2020);

h the acquisition of Swissbit Holding AG by its management and PE firm Ardian (2020; amount undisclosed); and

i the sale of NBE-Therapeutics AG by PPF Group to Boehringer Ingelheim (2020; €1.18 billion).

Exits of PE investments in Swiss portfolio companies by way of trade sales or secondary sales are by far the most common routes. While exits by way of an IPO (on Swiss stock exchanges such as SIX or a foreign stock exchange) are less common, recent examples include the IPOs of ADC Therapeutics SA (NYSE; 2020), SoftwareONE Holding AG (SIX; 2019), Medacta Group SA (SIX; 2019) and Achiko AG (SIX; 2019).

ii Operation of the market

Sales process

Private targets

In a seller's market, an increasing number of buyout transactions are structured as bid processes, where several bidders are invited to conduct a limited due diligence and submit indicative offers along with preliminary comments on the contractual documentation prepared by the sellers' advisers and negotiations ensue with the preferred bidders selected not only in consideration of the price offered, but also on the basis of other factors including the proposed legal terms (such as conditions precedent, scope of the expected representations and warranties and related indemnification regime), the ability to complete the transaction without having to arrange acquisition debt financing or the attractiveness of compensation packages for the management (e.g., equity incentive schemes). In this competitive environment, we observe a trend, at least in small and middle market transactions, towards buyers conducting more and more limited due diligence investigations, sometimes replaced by questionnaires to be filled in by the sellers, to reduce the transactions costs and speed up the deal process.

In line with industry standards (although Switzerland may appear as a high-priced market), prices in buyout transactions are commonly determined using multiples applied to financial results (such as EBIT or EBITDA) with adjustments based on net debt and working capital. Locked-box mechanisms are used in an increasing number of deals. Earn-out structures are also fairly common, especially where the seller or founder remains active within the target company post-closing, although such structures may give rise to tax pitfalls in certain situations.

The contractual documentation used in buyout or investment transactions involving a Swiss target company (non-disclosure agreement, letter of intent, term sheet, process letter, share purchase agreement, investment agreement, shareholders' agreement, financing and security agreements in leverage buyouts, etc.) is fairly standardised and contains customary terms and conditions, including a set of representations and warranties to be given by the seller in the share purchase agreement or by the existing shareholders or founders in the investment agreement. However, in a seller-friendly environment, sellers may have traction to negotiate lighter representations, warranties and indemnities, reduced liability cap and higher deductible amounts, and more favourable escrow arrangements. Of note, representations and warranties are usually not given by the Swiss target company (even in investment agreements) because enforcement may raise issues from a corporate and tax perspective. Further, reverse break fees and no-shop/go-shop arrangements are more and more common.

The Swiss market has also seen the continuing development of warranty and indemnity (W&I) insurances covering transaction-related risks such as representations and warranties and specific indemnities given by the seller, although the use of such insurances in Swiss deals is not (yet) as customary as in other jurisdictions. In Switzerland as in most other markets, the vast majority of W&I insurances are purchased by the buyer (with the insurance being often introduced, 'stapled', by the sell-side and then 'flipped' over to the buy-side) with no or very limited recourse against the seller, thereby facilitating a clean exit for the seller. By using W&I insurances, PE firms may make their bids more attractive in competitive auction processes when investing, and limit their post-closing liability exposure when divesting.

The time required to evaluate, structure, negotiate and complete a buyout transaction can vary considerably depending on a number of factors. The process can take several months where the buyer needs to arrange acquisition debt financing or where the seller or the buyer needs to secure a pre-closing tax ruling, obtain regulatory approvals or fulfil other conditions precedent.

Public targets

Going-private transactions led by PE sponsors over companies listed in Switzerland are relatively rare compared to other jurisdictions (such transactions being generally carried out by strategic existing shareholders or buyers), while the Swiss market has seen in recent years a number of public investment in private equity (PIPE) transactions involving PE funds. A going-private transaction is usually structured as a public tender offer pursuant to the Financial Market Infrastructure Act (FMIA) and its implementing ordinances, followed by the delisting of the target's shares and the squeeze-out of the remaining minority shareholders. A going-private transaction can also be effected by way of a merger pursuant to the Merger Act, although such a structure is less common in practice.

Upon successful completion of the public tender offer, the bidder will seek to squeeze out the remaining minority shareholders. In broad terms, two alternative routes are available:

a if the bidder holds more than 98 per cent of the voting rights in the target company after completion of the tender offer, it may apply, under the FMIA, for a court decision cancelling the remaining equity securities issued by the target company in exchange for the payment to the remaining minority shareholders of a cash compensation per share equal to the offer price; and

b if the bidder holds less than 98 per cent but at least 90 per cent of the voting rights in the target company, it may implement a squeeze-out merger pursuant to the Merger Act, whereby the target company would be merged into the bidder or an affiliate of the bidder and the remaining minority shareholders would receive a cash compensation (in general equal to, but not higher than, the amount of the price of the tender offer) in exchange for their shares in the target company.

In practice, the squeeze-out pursuant to the FMIA is the preferred route because courts in principle have no power to reconsider the amount of the cash compensation to be received by the minority shareholders. In contrast, in a squeeze-out merger, the minority shareholders have appraisals rights and may challenge by way of a legal action the amount of the (cash) compensation on the grounds that it is not adequate having regard to the value of their shares, even if such compensation is equal to the offer price. In addition, the tax treatment of the compensation is generally more favourable for the minority shareholders in a squeeze-out under the FMIA.

In parallel to the squeeze-out process, the target company will apply for the delisting of the shares in accordance with the rules of the relevant stock exchange (such as SIX or BX Swiss). Under the current law, the competent corporate body for resolving upon the delisting is the board of directors of the target company, but the authority to decide the delisting will be granted to the general meeting of the shareholders under the new statutory provisions of Swiss company law that are yet to enter into force (see Section IV). Pursuant to the rules of SIX, the listing must be maintained for a certain period of time (in principle at least three months but maximum 12 months depending, inter alia, on the remaining free float, with the possibility to reduce the listing period down to five trading days in certain cases; for instance, if the squeeze-out has already been completed or if the delisting was announced as part of the public tender offer), while the target company may apply for exemptions from certain obligations (such as ad-hoc or other reporting duties) during the continued listing period.

The timing for carrying out a going-private transaction by way of a public tender offer will depend, among other factors, on the pre-offer negotiation with the target company and anchor shareholders, the need for the bidder to secure funds to finance the offer and the time required to establish the fairness opinion. The process may take 9 to 12 months from start to finish, including completion of the squeeze-out and delisting.

Management equity incentive schemes

PE firms investing in Switzerland are generally keen to implement equity incentive schemes for the management of the portfolio company with a view to aligning the managers' interests with those of the PE investors.

In owner buyouts transactions (OBO), PE investors may allow (or sometimes require) the owners managing the target company to reinvest a portion of the sale proceeds by acquiring a minority equity stake in the special purpose vehicle (SPV) set up to complete the buyout, either by way of a share capital increase or by purchasing shares held by the PE investors, and by granting (subordinated) shareholders' loans to the SPV *pari passu* and pro rata with the PE investors.

At the level of the portfolio company, standard management equity incentive schemes include the following:

a stock option plan, whereby the managers are granted for free the option to acquire equity in the portfolio company at a preferred strike price during a certain exercise period; and

b stock plan, whereby the managers are granted, for free or on preferred terms, straight equity subject to blocking periods or restricted stock units (RSUs), sometimes in combination with performance stock units (PSUs).

The underlying instruments can be ordinary shares with voting rights, or equity securities with the same economic rights as ordinary shares but without voting rights.

Typically, equity incentive schemes contain vesting conditions, forfeiture provisions, repurchase rights in favour of the portfolio company or the PE investors in good or bad leaver situations, and acceleration mechanisms in the event of an exit. Further, the managers are usually required to enter into shareholders' agreements or similar contractual arrangements, providing for customary drag-along right, call options and right of first refusal in favour of the PE investors.

Tax considerations are key when it comes to structuring and implementing equity incentive schemes. As a rule, where the benefits under the plans are linked to the managers being employed or otherwise at the service of the portfolio company and the managers can acquire equity on preferred terms (sweet equity), Swiss tax authorities consider that the shares or other equity instruments are subject to taxation (and social security contributions) (1) upon exercise of the options under a stock option plan and (2) at grant under a stock plan. The taxable amount is calculated as the difference between the fair market value and the price, if any, at which the shares or other equity instruments are acquired by the managers. However, managers who are tax-resident in Switzerland will generally realise a tax-free capital gain upon the subsequent sale of their equity participations, typically in the event of an exit. In practice, the tax treatment of equity incentive schemes should be determined by way of a tax ruling, in particular by defining a suitable formula to establish the value of the portfolio company's shares during the lifetime of the investment.

For tax reasons, phantom or other virtual stock plans with cash settlement are less attractive for the management, hence less common, in Switzerland because under such plans, the managers realise a mere taxable income and are not in a position to realise a tax-free capital gain in case of an exit.

II LEGAL FRAMEWORK

i Acquisition of control and minority interests

Generally speaking, Switzerland is an attractive jurisdiction for PE investments thanks to its liberal and flexible legal framework. In particular, the acquisition of controlling interests in Swiss target companies is not subject to foreign investment restrictions. However, specific regulations may apply where the target company is a financial institution or carries on business in the telecommunication or residential real estate sectors. Further, PE transactions whereby control over the target company is acquired may be subject to merger clearance by the Swiss competition commission if the thresholds set by Swiss anti-trust law are reached.[7]

PE investors will generally control the target company when acquiring a majority equity interest (i.e., typically shares representing more than 50 per cent of the voting rights of the target company). However, Swiss company law provides for certain rights aiming at protecting the minority shareholders, including, for example:

a the right to request that a shareholders' general meeting be convened or items be put on the agenda provided that the requesting shareholders hold at least a certain percentage of the company's share capital; or

b the right to subscribe for new issued shares pro rata their participation, although such right can be withdrawn or limited for valid reasons by a shareholders' resolutions requiring a qualified majority; or

c the principle of equal treatment that the board of directors must comply with, unless for valid reasons.

In addition, certain resolutions of the shareholders' general meeting require a qualified majority of two-thirds of the votes and the absolute majority of the capital represented at the meeting. In contrast, minority shareholders have, as a rule, no statutory obligations with regard to the majority shareholders. Contractual duties may be imposed on the minority shareholders in shareholders' agreements, such as, for example, co-selling obligations (drag-along), share transfer restrictions (e.g., lock-up), obligation to sell their shares upon occurrence of specific events (call options), or undertaking to waive their preferred subscription right in certain circumstances.

In the case of a minority interest acquisition, especially in venture capital transactions, specific rights may be granted to PE investors, including veto rights or supermajority requirements concerning significant shareholder and board matters, right to appoint board representatives, economic preference rights (e.g., in terms of dividend, liquidation proceeds or exit proceeds), co-selling rights (tag-along), right of first refusal, anti-dilution rights (e.g., in the event of a future down round) and information rights. These rights are usually contractual in nature and provided for in the shareholders' agreement. They may be mirrored in the target company's articles of association but only to the extent permitted by Swiss law, meaning in effect that a full replication is generally not possible.

The acquisition of equity interests in a Swiss non-listed company may trigger disclosure duties. Indeed, any person or entity acquiring 25 per cent or more of the capital or voting rights of a Swiss non-listed company must notify the company of the acquiring entity's beneficial owner or owners and update such information in case of changes. In a typical PE structure, the general partner takes the relevant decisions regarding the fund and the underlying portfolio companies. As a result, the individuals controlling the general partner (respectively controlling the ultimate shareholder of the general partner) should be disclosed

7 In a nutshell, the obligation to notify a 'concentration of undertakings' (including mergers and acquisitions) applies, subject to certain exceptions (for instance, in the case of an established market dominant position), where the following thresholds are reached: (1) the concerned undertakings together have a turnover of at least 2 billion Swiss francs, or a turnover in Switzerland of at least 500 million Swiss francs; and (2) at least two of the concerned undertakings each have a turnover in Switzerland of at least 100 million Swiss francs.

as beneficial owners to the Swiss non-listed target company if the PE fund is acquiring 25 per cent or more of the capital or voting rights in that company. If such individuals cannot be identified in accordance with the Swiss disclosure rules, the Swiss company shall be provided with a negative declaration. However, the information disclosed is not publically available in the commercial register and will remain with the target company.

Where a PE firm seeks to take control of a company listed in Switzerland for the purpose of a going-private transaction, the rules set out by FMIA and its implementing ordinances on disclosure duties and mandatory public tender offer must be complied with. During the stake building, if equity securities are acquired, directly or indirectly, or in concert with others, resulting in certain thresholds being reached or exceeded (i.e., 3, 5, 10, 15, 20, 25, 33⅓, 50 or 66⅔ per cent of the voting rights of the target company, whether exercisable or not), notification must be made to the target company and the stock exchange on which the equity securities are listed. Further, if equity securities are acquired, directly or indirectly, or in concert with others, such that the threshold of 33⅓ per cent of the voting rights (whether exercisable or not) of the target company is exceeded, then a mandatory public tender offer must be launched for all the listed equity securities of the target company at a price to be at least equal to the minimum price as determined by applicable regulations. However, companies listed in Switzerland may provide, in their articles of association, for the increase of the relevant threshold up to 49 per cent of the voting rights ('opting-up'), or even for the non-applicability of the mandatory public tender offer rules ('opting-out') subject to certain conditions where the opting-out is introduced after listing. In addition, the Swiss Takeover Board may grant exemptions to the duty to make a public tender offer in justified cases, in particular where the target company is in financial distress and equity securities are acquired for restructuring purposes.

ii Structuring considerations

Most PE transactions in Switzerland are share deals whereby PE investors buy out shares in the target company, or invest monies in the target company in exchange for new shares issued through a share capital increase, often in combination with convertible loans (especially in venture or growth capital transactions). Asset deals are far less common and are more likely to be seen in distressed or restructuring scenarios or as a preliminary step for the carve-out of a business that is transferred to a newly created company whose shares are to be sold in a second step.

The acquisition of shares in the target company is often structured as a leverage buyout (LBO) and is thus financed by a mix of equity and debt. In that structure, PE investors typically acquire the target company through an SPV that is directly or indirectly held by the investing PE fund. The purchase price and the costs of acquisition are financed, in part, by equity and (subordinated) shareholders' loans provided by PE investors to the SPV and, in part, by (senior) loans provided by lenders to the SPV. A security package is put in place at closing to secure the lenders' rights (see below for an overview of certain issues that may arise in connection with 'upstream' or 'cross-stream' security interests).

The structuring of the acquisition of a Swiss target company by a foreign PE firm is mainly driven by tax and financing considerations, including, among others, the following.

a Tax treatment of capital gain and dividend income: the Swiss tax regime offers participation reliefs for Swiss tax-resident corporate shareholders holding qualifying participations. For dividends, the relief is available to Swiss tax-resident corporate shareholders holding at least 10 per cent of the share capital of the (Swiss or non-Swiss) company paying the dividend or shares in such paying-company with a fair market value of at least 1 million Swiss francs. For capital gains realised on the sale of equity securities, the relief is available to Swiss tax-resident corporate shareholders having sold at least 10 per cent of the shares of the (Swiss or non-Swiss) company provided such participation has been held for at least one year. The participation relief works as a partial or full reduction of the taxes rather than of the taxable basis. The participation relief is in principle not available to investments in collective investments, generally considered as tax transparent schemes, or to other transparent entities.

b Withholding tax: Swiss withholding tax at a rate of 35 per cent applies to dividend payments, deemed profit distributions and payment of liquidation proceeds made by a Swiss company. Swiss withholding tax is not levied on repayment of paid-in share capital (nominal value), or on distributions made out of qualifying capital contribution reserves. Swiss tax-resident entities or individuals can fully reclaim withholding tax provided they comply with applicable requirements. Non-Swiss shareholders may benefit from full or partial refund or reduction at source under double taxation treaties. When structuring a buyout transaction, it is important to determine whether the (foreign) seller of the Swiss target company is effectively entitled to a full withholding tax exemption under a double taxation treaty with Switzerland, because otherwise the buyer may inherit from a latent withholding tax burden. In addition, the Swiss federal tax administration has recently introduced a practice based on anti-abusive considerations, whereby withholding tax may also apply to dividends and similar distributions paid by the Swiss target company to the Swiss acquisition vehicle if such vehicle is held by the PE firm directly or by a foreign shareholder that does not benefit from a full withholding tax exemption ('extended international transposition'). In absence of treaty protection, a withholding tax issue may also arise from the merger post-closing of the target company into the acquisition vehicle, if the acquisition vehicle benefits from a more favourable withholding tax treatment on dividends than the seller. The risk is that all hidden reserves may be subject to withholding tax ('deemed liquidation theory'). To clarify the tax treatment, it may be advisable to obtain a tax ruling pre-closing.

c Deductibility of interest: Under the Swiss tax regime, interests on loans are, as a rule, tax deductible and not subject to Swiss withholding tax. However, certain exceptions apply, for example where the debt-to-equity ratio for related-party loans is not in line with the applicable thin capitalisation rules (hidden equity), or the interest rates for related-party loans are not at arm's length (hidden distribution), or loans are treated as bonds or notes ('10/20 non-bank rule'). Limitations may further apply if the Swiss acquisition vehicle is merged into the Swiss target company (debt push-down).

d Tax treatment of management equity management schemes; see above.

In that context, the legal form of the PE fund, in particular whether or not it is deemed a transparent entity for tax purposes (flow through structures), as well as the tax residency of the general partners or PE investors, are key elements to be considered. For an overview of certain Swiss taxation aspects in relation to Swiss private equity vehicles, see the chapter on Switzerland in the Fundraising part of this book.

Further to the entry into force of the corporate tax reform on 1 January 2020, preferential tax regimes previously available at the cantonal level (such as holding company, mixed company and domicile company) have been abolished. As a result, all Swiss companies are now subject to ordinary taxation. To mitigate the de facto increase of the corporate tax rates for the companies that no longer benefit from such preferential tax regimes, the cantons have reduced the corporate tax rates applicable to all companies. In addition, specific measures have been introduced to alleviate the consequences of the transition from preferential taxation to ordinary taxation (including patent boxes and increased tax deduction for research and development).

An exit of a controlling equity interest by way of a share buyback is generally not possible because under Swiss law a company may repurchase its own shares only to the extent that (1) it has freely distributable reserves in an amount sufficient to pay the purchase price and (2) the aggregate par value of all shares owned by it does not exceed 10 per cent of the issued share capital. In addition, selective share buybacks are only permitted under certain circumstances having regard to the principle of equal treatment of shareholders. Further, the tax treatment may not be optimal for the foreign selling shareholders where the shares so repurchased by the company exceed the 10 per cent threshold or are subsequently cancelled by way of a share capital reduction.

iii Fiduciary duties and liabilities

As a rule, under Swiss company law, shareholders of Swiss companies limited by shares have no statutory obligation other than to pay in the subscription amount of their shares and are not liable for the company's debts. In exceptional circumstances and subject to restrictive conditions as set by case law, shareholders may be liable for the company's actions; for instance, where invoking the separate legal existence of the company is held abusive (piercing the corporate veil) or where shareholders are deemed de facto management bodies of the company. The same principles apply to shareholders of Swiss limited liability companies with the caveat, however, that such shareholders are under statutory obligations (which can be waived with the other shareholders' consent) to safeguard business secrecy (confidentiality duty) and to refrain from actions or omissions detrimental to the company's interests (fidelity duty). Subject to the foregoing, PE sponsors and investors in their capacity as shareholders do not owe fiduciary duties to the other shareholders of the portfolio company or to the portfolio company itself. Accordingly, unless otherwise agreed by contract (e.g., by way of shareholders' agreements), PE sponsors and investors are free to pursue their own interests when exercising their shareholders' rights under the articles of association and the law. However, the majority shareholders' right to pass resolutions resulting in their interests prevailing over those of the minority shareholders may be limited under the doctrine of abuse of right: this may be the case where the majority shareholders pass resolutions that withdraw or limit the minority shareholders' rights without any reasonable economic or other objective ground, resulting in the minority shareholders' interests being blatantly harmed without legitimate justification.

The representatives of the PE sponsor or investors on the portfolio company's board of directors are bound by the same fiduciary duties as the other members of the board and executive management. These fiduciaries duties include the following:

a the duty to act with due care and diligence;

b the duty to loyally safeguard the company's legitimate interests (fidelity duty), meaning that the members of the board and executive management must act in the portfolio company's best interests which shall prevail over their own personal interests or the interests of the shareholders that have appointed them. This may lead to conflict of interests, in which case the members of the board and executive management must take measures to properly prevent and deal with such conflicts, including by informing the board and refraining from discussing and voting on the concerned items; and *c* the duty to treat all shareholders equally. This principle, however, is not absolute and only applies to shareholders that are in the same position. Exceptions may be permitted depending on the circumstances and provided that a differentiated treatment can be justified by valid reasons having regard to the company's interests.

Members of the board and executive management may incur personal liability if they breach their fiduciary duties by willful misconduct or negligence, thereby causing harm to the company, the shareholders or the creditors. In practice, the discharge granted by the shareholders' general meeting to board members does not afford an absolute protection against liability claims, as the discharge is only effective for facts known to the general meeting and is not opposable to creditors or to the bankruptcy administration. To mitigate the risk of personal liability, directors' and officers' insurances can be arranged and entering into director indemnification agreements with the company may be considered to the extent permitted by applicable law.

Given the risk of personal liability faced by board members, PE firms sometimes appoint observers as representatives on the board of the portfolio company, especially in minority venture capital transactions. Usually, observers may attend board meetings, participate in discussions and have access to information, but cannot vote on board matters. Under Swiss company law, there are no statutory provisions dealing with board observers. In most cases, the shareholders' agreement will set the (contractual) rules governing the appointment and status of board observers. However, in certain circumstances observers may be considered de facto board members, and hence will be subject to the same personal liability regime as formally appointed directors: this may be the case where observers have exercised a decisive influence on the decision-making process from a functional perspective even in the absence of voting rights.

iv Financing

Acquisition debt

In Swiss LBO deals, depending on the transaction size and type, acquisition debt financing used by PE sponsors typically takes the following forms:

a senior loans only, typically used in smaller deals or where the PE sponsors use very little leverage;

b unitranche loans, typically used in smaller or middle-market deals and which combine senior and subordinated debts into one instrument and are often provided by non-traditional lending institutions such as debt funds; usually, unitranche loans are granted by a single lender under a single set of documents and are structured as bullet-repayment loans with a single interest rate, sometimes with equity warrants; and

c multiple layers financing, which are typically used in larger deals and may include senior loans provided by banks and other financial institutions under syndicated credit facility agreements, second-lien loans, mezzanine loans and high-yield bonds.

Acquisition debts are often combined with revolving credits to finance general corporate purposes and with the refinancing of the target company's existing indebtedness at closing.

The key non-pricing terms of acquisition debts for Swiss LBO transactions (including affirmative, negative, financial covenants, security requirements and default provisions) are comparable to those found in international transactions.

Generally, the debt-equity ratio in Swiss LBO transactions is less aggressive than in US or UK transactions. Where the borrower is a Swiss entity (SPV) and PE investors provide (subordinated) shareholders' loans in addition to equity to finance the acquisition, thin capitalisation rules may limit the applicable debt-to-equity ratio (see above).

Security package

In a typical Swiss LBO structure, PE sponsors create a SPV to acquire the target company and incur the acquisition debt as borrower. At closing, a security package will be put in place to secure the lenders' rights under the acquisition debt financing. The scope of the security package typically depends on the transaction size and type (e.g., acquisition of a minority, majority or 100 per cent stake in the target company). In smaller deals, the required security interests may comprise only the pledging by the SPV of the shares of the target company. In larger deals, especially where a 100 per cent stake is acquired in the target company, the security package is often more extensive and may cover security interests granted by the target company over its own assets (such as pledge or assignment for security purposes of bank accounts, IP rights, trade receivables or shares in subsidiaries).

Where the Swiss target company grants security interests over its own assets to secure the obligations of its direct or indirect shareholders (typically, the SPV's obligations under the acquisition debt financing), this structure gives rise to a number of issues from a Swiss corporate, tax and insolvency law perspective ('upstream security'). In particular, the amount that can be paid out to the lenders upon enforcement of the security is in principle limited to the amount of the target company's freely distributable reserves at the time of enforcement. In addition, the granting of upstream securities must be covered by the corporate purpose of the target company and appear in its (own) corporate interest. Furthermore, corporate formalities may have to be completed upon the granting or enforcement of the security, including shareholders' and board approvals and issuance of audit reports. The same issues arise where a group company grants security interests to secure the obligations of its direct or indirect sister companies ('cross-stream security'). Because of the limitations flowing from Swiss law, financing structures involving upstream or cross-stream security interests should be carefully analysed and properly documented and implemented, especially in the presence of minority shareholders where the transaction does not comprise the acquisition of a 100 per cent stake in the target company.

III REGULATORY DEVELOPMENTS

As a rule under Swiss law, PE transactions (whether investment or exit transactions) in and of themselves are not subject to specific regulatory obligations or oversight. However, specific rules may apply in relation to transactions in certain regulated industries, such as banks, insurances or other financial institutions, telecommunications and real estate. For an overview of the Swiss regulatory framework applicable to PE funds, managers and investors, see the chapter on Switzerland in the Fundraising part of this book.

Shareholders' and board approvals at the level of the portfolio company may be required for certain types of exits; for example, in the case of a merger, spin-off, transfer of all or substantially all the assets or liquidation of the portfolio company. Further, an exit transaction may be subject to anti-trust clearance if the applicable thresholds are reached.

IV OUTLOOK

The revision of Swiss company law was adopted by the Swiss parliament in June 2020, and features, inter alia, the following notable changes that may be relevant in the context of PE transactions:

a companies may state their share capital in their functional currency (i.e., the most important currency of the business; currently only in Swiss francs);

b the shareholders' general meeting may decide to specify a 'capital band' of up to 50 per cent of the share capital in the company's articles of association, and authorise the board of directors to increase or reduce the share capital within such band during a period of no more than five years;

c the distribution of interim dividends is expressly permitted (while this is a disputed matter under the current law), provided that the distribution is based on interim financial statements that must be audited subject to certain exceptions;

d the authority to decide (with a qualified majority) the delisting of the company's shares lies with the shareholders' general meeting (while the board of directors is the competent body under the current law);

e minority shareholders' rights are reinforced in a number of areas; in particular, in the case of non-listed companies, shareholders holding at least 10 per cent of the share capital or voting rights may request information from the board of directors on company matters at any time, and those holding at least 5 per cent of the share capital or voting rights may request to inspect the company's books at any time and that an item be included on the agenda of the shareholders' general meeting;

f revision of the statutory provisions applicable in case of impending insolvency, capital loss and over-indebtedness;

g large commodities companies must disclose in a report to be published any payments, in cash or in kind, exceeding 100,000 Swiss francs per financial year made to public authorities (including companies controlled by governmental authorities); and

h revision and implementation of specific rules applicable to listed companies, including in relation to management remunerations and gender quotas.

The provisions applicable to commodities companies and gender quotas entered into force on 1 January 2021, while all other provisions are expected to enter into force in the course of 2022.

Overall, this major revision aims at reinforcing corporate governance, introducing more flexible rules and modernising Swiss company law. Thanks to this positive legislative evolution, combined with its robust, diverse and internationally oriented economy, Switzerland is likely to remain a prominent market for domestic and cross-border PE investments in years to come, despite the uncertainties associated with the covid-19 global pandemic.

Chapter 13

UNITED STATES

Aisha P Lavinier and Melanie B Harmon[1]

I OVERVIEW

i Deal activity

The year 2020 was a volatile one for US private equity. Although the buyout market ended 2020 on a high note, with deals count and volume surging in the fourth quarter, there was a clear mid-year lull in deal activity, driven by the global covid-19 pandemic. A noticeable rise in special purpose acquisition company (SPAC) transactions in 2020 buoyed numbers to some extent, and the sharp increase in the number of new SPACs raised in the second half of 2020 suggests that the SPAC trend will continue in 2021.

Buyouts

Private equity sponsors completed 3.4 per cent fewer US buyout transactions in 2020 than in 2019, while the total amount invested fell by 7.3 per cent.[2] Despite this decline, private equity firms led a number of large buyouts, including: the US$22.8 billion take private of Kansas City Southern by Blackstone Private Equity and Global Infrastructure Management LLP, US$11.4 billion take private of Dunkin' Brands by Roark Capital Group and Inspire Brands and the US$9.5 billiion take private of by RealPage, Inc by Thoma Bravo LLC. Within the buyout category, the 2020 market for private equity sponsor-led take-private transactions declined by over 50 per cent in the number of completed deals, with the aggregate value of those deals falling by over 73 per cent compared with 2019. However, the number of add-on transactions completed by US private equity sponsors continued to increase in 2020, accounting for approximately 72 per cent of all buyouts.

Growth equity

US growth equity investments by private equity firms (i.e., purchasing a minority equity stake in a mature firm) surged in 2020, with the aggregate reported value of such deals increasing by 8.8 per cent compared to 2019. Harvest Partner's, TA Associates' and GI Partners' US$3.5 billion investment in MRI Software was 2020's largest growth equity transaction and total US growth equity investments reported by Pitchbook totalled over US$62.5 billion across 810 deals.[3]

1 Aisha P Lavinier and Melanie B Harmon are partners at Kirkland & Ellis LLP. The authors thank Stephen Ritchie, Paul Anderson and the firm's research staff for their help in drafting this chapter.
2 Source: PitchBook, 2020 Annual US PE Breakdown.
3 ibid.

Exits

Exit volume in 2020 remained below the most recent 2018 peak. Although exits were down 14 per cent year-over-year by count, aggregate deal value did increase slightly, up 6 per cent. Eight of the 10 largest exits in 2020 consisted of sponsor-backed public listings.[4] Notable sales in 2020 included Thoma Bravo's US$11 million sale of Ellie Mae to Intercontinental Exchange, Centerbridge Partners' public listing of GoHealth at a US$6.5 billion valuation, KKR's sale of Epicor to Clayton Dubliner & Rice for US$4.7 billion and Providence Equity Partners' sale of ZeniMax Media to Microsoft for $7.5 billion.

The modestly stronger exit numbers in 2020 were driven in part by an increase in sponsor-backed initial public offerings (IPOs) and SPAC transactions. The number of SPAC IPOs saw a sharp increase from 2019 to 2020 both in number (248 SPAC IPOs in 2020 compared to 57 in 2019) as well as capital raised (US$75.3 billion in 2020 compared to US$11.6 billion in 2019). The sponsor-led public listing market also rose meaningfully in 2020, nearly matching the 2013 peak in aggregate deal value; 35 PE-backed companies went public in 2020 for an aggregate exit value of US$100.6 billion.[5] Notable US PE-backed SPAC transactions in 2020 included Hellman & Friedman-owned hedge fund GCM Grosvenor, HydraFacial (backed by Linden Capital Partners and DW Healthcare Partners) and Blackstone Group's and CVC Capital Partners' Paysafe.[6]

In 2020, secondary portfolio company buyouts (i.e., sponsor-to-sponsor transactions) fell dramatically, however, bucking recent trends. Sponsor-to-sponsor transactions accounted for just over 33 per cent of overall exit value (down from over half of overall exit value in 2019), which represents a 50 per cent decrease compared to 2019.[7] Finally, general partner (GP)-led secondary offerings (i.e., secondary sales of limited partner (LP) interests in an existing fund) continued to increase in 2020.

Financing

The overall volume of US debt financing was down year-on-year, mirroring the overall decline in deal volume. Total US dollar-leveraged lending in 2020 fell compared with 2019 levels.[8] Lending to private equity sponsors for all purposes, including M&A, refinancing and dividend recaps, also experienced a sharp decline from 2019's numbers.[9]

The 2020 buyout market saw a slight increase in year-over-year leverage levels. For example, the average debt multiple for larger broadly syndicated leveraged buyouts (LBOs) increased from 5.3 times earnings before interest, tax, depreciation and amortisation (EBITDA) to 5.4 times EBITDA.[10]

Fundraising

Even more so than the overall deal activity in 2020, fundraising by sponsors fell by 36.6 per cent in 2020, down to US$203.2 billion. Despite overall lower fundraising figures, 2020 saw an increasing market share of fundraising for technology-focused funds, with large players

4 ibid.

5 ibid.

6 ibid.

7 ibid.

8 Source: S&P Global Market Intelligence LCD's Quarterly Leveraged Lending Review: 4Q 2020.

9 ibid.

10 ibid.

like Thoma Bravo and Vista Equity, as well as smaller middle-market players like Sumeru Equity and Accel-KKR, attracting new commitment in excess of all prior years other than 2019. Fundraising for 'long-dated' funds in 2020 continued its recent growth trend as well.[11]

ii Operation of the market

The US market for corporate control is very efficient. Many private targets are sold through an auction run by investment bankers or similar intermediaries. While a smaller proportion of public targets are sold through a full-blown auction, the legal framework (in general) attempts to duplicate an auction by encouraging a target's board of directors to follow a process designed to secure the highest reasonably attainable price for stockholders.

Public targets

From a legal point of view, the US market for sponsor-led going-private transactions is driven primarily by the following considerations:

a the fiduciary obligations of the target's board of directors, as defined by the laws of the target's state of incorporation (most frequently, Delaware);

b financing risks; and

c the rules of the Securities and Exchange Commission (SEC) regarding tender offers or proxy solicitations.

Each of these factors influences not only the time required to purchase a US public target but also the transaction's structure.

Delaware courts have held that when a target's board decides to sell the company it must satisfy what are known as Revlon duties.[12] Revlon requires a contextually specific application of the board's normal duties of care and loyalty designed to ensure that it conducts a process to seek and attain the best value reasonably available to the target's stockholders. There is no single, court-prescribed course of action for a board to follow (e.g., conducting a pre-signing auction for the target or always using a special committee of disinterested directors to negotiate with a suitor). However, certain conventions – such as fiduciary outs and limits on termination fees and other deal protections – have arisen in response to guidance from Delaware courts to balance the target board's obligation under *Revlon* and the bidder's desire to obtain deal certainty. For example, many deals feature a 'go-shop' exception to a target's customary 'no-shop' covenant.[13] In a typical go-shop, the target is given a window – usually 25 to 40 days – to actively seek a superior offer. If a qualifying topping bid emerges during the go-shop period, the target may terminate its agreement with the original acquirer by paying a reduced termination fee and enter into a new agreement with the higher bidder. Most

11 ibid.

12 *Revlon v. McAndrews & Forbes Holdings, Inc* (Del Sup Ct 1986). Many states do not follow Revlon; some states, such as Indiana (Indiana Code Section 23-1-35-1(d)), Pennsylvania (Pennsylvania Business Corporations Law Section 1715) and Wisconsin (Wisconsin Business Corporations Law Section 180.0827), have constituency statutes permitting directors to consider not only price, but also other stakeholders' interests, such as the target's employees, suppliers and communities in which the target operates, when considering a sale.

13 A no-shop covenant prohibits the target from actively seeking an acquisition proposal, but typically allows a target to respond to an unsolicited proposal that could reasonably be expected to lead to a better transaction for target stockholders.

importantly, from a private equity bidder's perspective, Delaware courts have concluded that a target board that does not conduct a pre-signing auction or market check can satisfy its *Revlon* duties by including a go-shop in the merger agreement, so long as the rest of the process and other deal protections are satisfactory.[14]

Parties to a US leveraged take-private must contend with the risk that debt financing may not be available at closing. Unlike in some other countries (e.g., the United Kingdom), 'certain funds' (i.e., a fully negotiated and executed credit agreement between a buyer and its lenders delivered at deal announcement) are neither required nor available in the United States, and financing commitment letters, no matter how 'tight' (i.e., lacking in preconditions), cannot be specifically enforced even if the providers of the letters have clearly breached their terms. In response, dealmakers have crafted a model that has become the most common (but by no means the sole) way to allocate the risk of financing failure.

This model generally allows a target to obtain, as its sole pre-termination remedy, an order from a court, known as an order for 'specific performance', forcing a buyer sponsor to make good on its commitment to provide the necessary equity financing and to complete the merger if, and only if, all the conditions to the merger are satisfied, the debt financing is available for closing and the target agrees to close when the equity is funded. If, on the other hand, the target chooses to terminate the merger agreement, either because the private equity sponsor is unable to close because the necessary debt financing is not available or otherwise breaches the agreement, then the sponsor must pay the target a reverse break-up fee (usually an amount greater than the target's termination fee) and the transaction is terminated. Payment of the reverse break-up fee is the target's sole and exclusive remedy against the sponsor and its financing sources, even in the case of a wilful breach.[15]

Parties to a sponsor-led take-private transaction add yet another level of complexity when they choose to proceed via a two-step tender offer (rather than a one-step merger). In a tender offer, the sponsor offers to purchase the shares of the target directly from the stockholders, obviating the need – at least in the initial step – for a stockholder vote. The sponsor's obligation to complete the tender offer is typically conditioned upon stockholders tendering more than 50 per cent of the outstanding shares. If this 'minimum tender' condition is satisfied, the sponsor must acquire all untendered shares in a 'back-end' merger, the terms of which are set out in a merger agreement executed by the target and buyer on the day they announce the tender offer. Depending on the circumstances of the deal, including the target's state of incorporation, the back-end merger can be completed immediately after the closing of the tender offer; otherwise, the buyer must engage in a long (three- to four-month) and expensive proxy solicitation process and hold a target stockholders' meeting before it can complete the back-end merger.

Failure to acquire all the outstanding stock on the same day the tender offer closes makes it much more difficult to use debt financing because of the application of US margin stock rules, a highly complex set of laws and regulations that, in general, prohibit any person

14 See, e.g., *In re Topps C S'holder Litigation* (Del Ch 2007) and *In re Lear Corp S'holder Litigation* (Del Ch 2007). There are many dimensions to a go-shop's terms, such as the length of the go-shop period, the size of the reduced fee and limitations on what constitutes a superior offer, each of which is taken into account when evaluating the board's compliance with Revlon.

15 Not all deals follow this model. In some deals, sponsors have assumed all the financing risk and granted the target full specific performance; on the other, rarer end of the spectrum, buyers have agreed to a two-tiered reverse break-up fee, with a smaller fee payable if debt financing is unavailable, and a larger fee payable if the sponsor breaches its obligation to close (even if debt financing is available).

from financing the acquisition of US public company stock with more than 50 per cent debt financing secured by the target's stock or assets. Many sponsor-led US take-private transactions are more than 50 per cent leveraged, so parties to such transactions must find solutions that satisfy the margin rules if they wish to enjoy the benefits of a tender offer.

The easiest way to avoid a delayed back-end merger is for the buyer to acquire in the tender offer a supermajority of the target's shares – in Delaware, 90 per cent – allowing the buyer to complete a 'short-form' merger immediately after closing the tender offer. By completing the back-end merger essentially simultaneously with the offer, a sponsor can more easily structure its debt financing to comply with the margin rules and lender demands for a lien on the target's assets. In most deals, however, it is not realistic to expect stockholders to tender such a large proportion of the outstanding shares.

Dealmakers address the potential delays of a full-blown back-end merger process and the complications presented by the margin rules largely by relying on a 'top-up' option or Delaware General Corporation Law Section 251(h).

Top-up option

In a top-up option the target agrees, upon completion of the tender offer, to issue to the buyer a sufficient number of its authorised but unissued shares to allow the buyer to reach the threshold required for a short-form, back-end merger. Delaware courts have approved the top-up option structure, with a few easily satisfied caveats,[16] largely because it puts money in stockholders' hands more quickly without harming their interests. The primary limitation of the top-up option is mathematical: the number of shares required to hit 90 per cent may be very large because the calculation is iterative, so it is often the case that a target does not have enough authorised but unissued shares in its constituent documents to utilise the top-up option.

Section 251(h)

Enacted by Delaware in August 2013, Section 251(h) eliminates, subject to certain conditions, the requirement for stockholder approval of a back-end merger after a tender offer for a listed company, or one with more than 2,000 stockholders of record, if the buyer acquires more than the number of shares required to approve a merger (typically a bare majority, but it could be more if the target's certificate of incorporation so requires) but less than the 90 per cent threshold for a short-form merger.

Section 251(h) is an important and useful innovation, as it allows the buyer to acquire all the outstanding shares and the non-tendering stockholders to receive the merger consideration without the lost time and expense of a three to four-month proxy solicitation process.[17] Furthermore, in June 2016, Delaware passed an amendment to Section 251(h) giving target management and other target stockholders the opportunity to exchange all or a portion of their target stock for buyer stock without running afoul of Section 251(h) rules, a

16 See *Olson v. ev3, Inc* (Del Ch 2011). The buyer must pay cash for at least the par value of the issued shares (with the remainder purchased with a demand note, the terms and conditions of which were approved by the target's board), and the top-up option shares must be ignored if any dissenting stockholder elects to seek an appraisal of its shares.

17 In 2014, the Delaware legislature amended Section 251(h) to eliminate the 'no interested stockholder' condition in the original statute, which essentially prohibited acquirers from entering into support agreements with target stockholders, a common feature of private equity sponsor take-privates.

limitation that had previously favoured the use of the top-up option in certain circumstances. As a result, the use of the top-up option, either in lieu of or as a backup in the event the Section 251(h) conditions cannot be satisfied, will continue to slow going forward.

Deal litigation

For many years, practitioners have accepted that stockholder lawsuits are simply part of the price of acquiring a public target, regardless of how well the target's board managed the sale process. Prior to 2016, the vast majority of public company deals valued over US$100 million faced at least one shareholder lawsuit.[18] These lawsuits, often filed within hours of a transaction's public announcement, were frequently settled for the target's promise to disclose additional information about the transaction process and the payment of a fee to the plaintiffs' lawyers. However, key 2015 and 2016 cases saw Delaware courts sour on these 'disclosure only' settlements.[19] In addition, recent case law has given additional clarity to deal process road maps that provide the target company with the 'business judgement' standard of judicial review, a standard that makes it difficult for plaintiffs to prevail.[20] While this trend has had the expected effect on the volume of nuisance lawsuits in Delaware, with public company merger litigation trending down over the past half-decade, there has been a partially offsetting increase in deal litigation in other states and federal courts as plaintiffs seek more favourable venues for claims.[21]

During 2016 and 2017, as litigation focused on allegedly flawed sale process declined, plaintiffs shifted their focus to appraisal actions. Delaware General Corporation Law Section 262 permits stockholders of Delaware corporations to seek appraisal of his or her shares in lieu of accepting the merger consideration negotiated by the target and the acquirer. Historically, Delaware courts had given substantial weight to the merger price in determining the true 'fair market value' of a stockholder's shares.[22] Several 2016 Delaware cases saw judges lessen or eliminate their historical reliance on the merger price as evidence of value and instead focus on financial projections and related discounted cash flow analysis to come to their own independent calculation of fair market value for a target.[23] These judicially derived values often varied substantially from the merger price. Interestingly enough, these 2016 cases suggested that Delaware courts were more apt to discount the deal price and give more

18 Cornerstone Research, Shareholder Litigation Involving Acquisitions of Public Companies, August 2016; Cain, Matthew D. and Fisch, Jill E. and Davidoff Solomon, Steven and Thomas, Randall S., The Shifting Tides of Merger Litigation (4 December 2017).

19 See, *In re Riverbed Technology, Inc.* (Del. Ch. 2015); *In re Aruba Networks, Inc. Stockholder Litig.* (Del. Ch. 2015); and *In re Trulia, Inc. Stockholder Litig.* (Del. Ch. 2016).

20 See, e.g., *Kahn v. M&F Worldwide Corp.* (Del 2014); *Corwin v. KKR Financial Holdings LLC* (Del. 2015); *Singh v. Attenborough* (Del. 2016); *In re Solera Holdings, Inc. Shareholder Litigation* (Del. Ch. 2017).

21 Cain, Matthew D and Fisch, Jill E and Davidoff Solomon, Steven and Thomas, Randall S., The Shifting Tides of Merger Litigation (4 December 2017).

22 Stockholder must vote against merger; merger consideration is all or part cash (i.e., no appraisal rights where target stockholders are being paid solely in shares of an acquirer listed on a national securities exchange); before the vote on the merger, the stockholder delivers to target a written demand for appraisal of his or her shares; and within 120 days of the effective date of the merger, the stockholder commences an appraisal proceeding by filing a petition demanding a determination of the value of his or her shares.

23 See, *In re Appraisal of Dell Inc.* (Del Ch. 2016); *In re Appraisal of DFC Global Corp.* (Del. Ch. 2016).

weight to their own analysis in instances where the acquirer was a private equity sponsor.[24] As a result, the plaintiffs' bar rushed to file appraisal actions in 2016 and 2017, particularly where the acquirer was a private equity sponsor. The year 2017 ended, however, on a sour note for plaintiffs eager to have a Delaware judge second-guess deal consideration. Two key appraisal cases were overturned by the Delaware Supreme Court on appeal, including one with a private equity acquirer.[25] The message in those cases was clear – Delaware courts should be deferential to the merger price unless there are sale process breakdowns that make the merger consideration suspect. Given the return to reliance on deal price as the primary indicator of value in appraisal actions as well as the covid-19 pandemic disrupting court operations, 2020 continued to see the volume of appraisal litigation in Delaware fall from 2016/2017 peak levels.[26]

Private targets

Because it is easier to maintain confidentiality and the consequences of a failed auction are less dire, a full-blown auction for a US private target is more common than for a public target. In an auction for a US private target, the target's advisers typically invite several bidders to conduct limited due diligence and submit indicative bids, with the highest and most credible bidders invited to conduct further due diligence and submit additional bids. The time required to sell a private target can vary considerably: an auction and sale process for a desirable private target can take, from start to finish, as little as two months, while other processes may take many months. If the buyer requires debt financing, the health of the debt markets also affects the length of the process.[27]

In an auction, a private equity firm must compete not only on price but also on terms, timing and attractiveness to management. While in the past private equity bidders often conditioned their bids on receiving necessary debt financing, in today's market such a condition is likely to affect the competitiveness of a bid adversely, particularly in a larger deal. Indeed, in the current market many private-target acquisition agreements (a clear majority in larger deals) contain the same conditional specific performance and reverse break fee mechanism now common in take-private transactions.

The US buyout market has also seen continued growth in the use of commercial insurance policies intended to protect buyers or sellers (or both) against various transaction-related risks such as breaches of representations and warranties. These insurance products often allow parties to bypass difficult negotiation over post-closing indemnification by shifting specified transaction risks to a sophisticated third party in the business of taking such risks. An increasing number of private equity firms have successfully used M&A insurance to either make their bids more attractive to sellers or limit their post-closing liabilities when exiting an investment.

24 The court in *Dell* found the fair market value to be 28 per cent higher than the merger price, while the courts in *DFC* and *Farmers* found the fair market value to be 7 per cent and 11 per cent higher than the deal price, respectively.

25 See, *In re Appraisal of Dell Inc.* (Del Ch. 2016); *In re Appraisal of DFC Global Corp.* (Del. Ch. 2016).

26 Cornerstone Research, Appraisal Litigation in Delaware: Trends in Petitions and Opinions 2006–2018.

27 While, in theory, *Revlon* and related principles of Delaware law apply equally to the sale of a private target as to a public target, in practice a buyer often deals directly with target stockholders (or at least controlling stockholders), minimising or even eliminating the board of directors' role and the related legal issues.

Management equity

Management equity practices vary across US private equity firms, but certain themes are common:

a executives with sufficient net worth are expected to invest side-by-side with the sponsor to ensure they have sufficient 'skin in the game';

b management equity entitles the holder only to modest stockholder rights – in some cases, only the right to be paid in connection with a distribution or liquidation;

c holders of management equity get liquidity when and to the same extent that the sponsor gets liquidity; and

d incentive equity (and at times part or all of management's co-invested equity as well) is subject to vesting, whether upon passage of time, achievement of various performance goals, or a combination of the two.

The size of the management incentive equity pool generally ranges from 5 to 15 per cent, depending on the mix between time- and performance-based vesting, with smaller deals generally congregating at the upper end of the range, and larger deals generally at the lower end.

The prospect of participating in a potentially lucrative incentive equity pool can be powerful motivation for management to prefer a private equity buyer over a strategic buyer unlikely to offer a similar plan (and who might fire management instead). A private equity bidder for a private target can use this to its advantage, particularly when management cooperation is key to a successful sale. When pursuing a public target, however, such a strategy carries additional risk, as Delaware courts, the SEC and the market are sensitive to the conflict of interest presented when a target officer – particularly the CEO – has a personal incentive to prefer one bidder over another.

For this reason, the board of a public target often instructs its management not to enter into an agreement with a private equity suitor regarding compensation or equity participation before the stockholders have voted on the deal (or tendered their shares to the buyer). Indeed, it is often in a private equity buyer's interest to not enter into an agreement with management before the stockholder vote, because the SEC (by way of its Rule 13e-3) requires substantial additional disclosure in such situations. In addition, management participation in a transaction prior to a stockholder vote may increase the risk (and potentially cost) of stockholder lawsuits opposing the deal.

II LEGAL FRAMEWORK

i Acquisition of control and minority interests

The US federal system – in which the federal (i.e., national) government exercises supreme authority over a limited range of issues, and the individual states exercise authority over everything else occurring within their respective jurisdictions, with overlaps seemingly everywhere, presents private equity firms with a complex legal maze to navigate when acquiring control of or investing in the equity of a target company. A private equity firm contemplating an investment in the United States confronts the following regulatory regimes:

a a federal securities laws and regulations, administered by the SEC;

b state corporation law (usually the Delaware General Corporation Law), alternative business entity law (usually the Delaware Limited Liability Company Act or the Delaware Limited Partnership Act) and securities laws (called 'blue-sky' laws);

c federal, state, local and foreign tax laws and regulations;[28]
d Hart-Scott Rodino Antitrust Improvements Act (the HSR Act) pre-merger antitrust review;
e particularly when making a minority investment in a public target, the rules of the stock exchange where the target's shares are listed, such as the New York Stock Exchange or the Nasdaq National Market;
f potential review by the Committee on Foreign Investment in the United States (CFIUS) of an investment by a non-US investor in a US target, if the investment threatens to impair national security; and
g industry-specific regulatory schemes – such as those found in the energy, pharmaceutical, medical device and telecommunication industries – that may require advance notification to or even approval by a governmental authority.

The first three regulatory schemes – federal securities laws, state corporate and securities laws, and tax – affect every investment a private equity firm may make in the United States. The HSR Act applies only if a deal exceeds specified levels,[29] and the applicability of the others depends on the nature of the target and, in some cases, the characteristics of the buyer as well.

In general, neither US federal securities laws and regulations nor Delaware corporate and other business entity laws focus upon the substance of a transaction. Rather, the federal scheme is designed to ensure that parties to the transaction – whether a direct sale of stock, a merger, a tender offer or issuance of shares – receive adequate disclosure, and in some cases adequate time to make a fully informed investment decision, and Delaware law is chiefly concerned with the process followed by the company's governing body when considering the transaction, except in the case of interested transactions, which are subject to entire-fairness review (looking at both process and price).

Regulatory schemes outside Delaware law and US federal securities laws and regulations, however, often do look at the substance of transactions and can be influenced by political movements. For example, deal practitioners have seen increased difficulty in getting clearance for transactions with Chinese and other foreign acquirers under the Trump administration.[30] The Trump administration was viewed as having taken a firmer stance on antitrust review of transactions – a development that took many by surprise.[31] It remains to be seen how the Biden administration will handle such matters.

28 The tax implications of any private equity transaction are tremendously complex. For a thorough discussion of the issues, see generally Ginsburg, Levin and Rocap (footnote 41).

29 See Kirkland Alert (February 05 2021) for the most recent HSR filing thresholds, available at www.kirkland.com/publications/kirkland-alert/2021/02/2021-hsr-revised-thresholds-announced?utm_source=emailplatform&utm_medium=email&utm_campaign=Alert&utm_term=Litigation&utm_content=afternoonct.

30 Source: *The New York Times*, Trump and Warren Find Common Ground on Antitrust.

31 ibid.

ii Fiduciary duties and liabilities

Corporations

In general, stockholders of a Delaware[32] corporation do not owe any duty, fiduciary or otherwise, to one another. Thus, a private equity firm is free to act in its own interest, subject to very limited exceptions,[33] when deciding to vote or sell its portfolio company stock, subject to contractual rights (e.g., tag-along or registration rights) of the company's other stockholders. On the other hand, a controlling stockholder may be liable to the corporation or its minority stockholders if the controlling stockholder enters into a self-interested transaction with the corporation at the expense of the minority.[34]

All directors (and officers) of a Delaware corporation, including sponsor representatives on the board, owe the corporation and its stockholders the following duties:

a a duty of care, requiring a director to be reasonably informed and to exercise the level of care of an ordinarily prudent person in similar circumstances;

b a duty of loyalty, requiring a director to act in the interests of the corporation and its stockholders and not in his or her own interest; and

c a duty of good faith, or perhaps better stated a duty not to act in bad faith, often described as the intentional or reckless failure to act in the face of a known duty, or demonstrating a conscious disregard for one's duties.

Subject to limited exceptions, when reviewing the conduct of a corporation's directors, Delaware courts will apply what is known as the 'business judgement rule', which presumes that a director acted with reasonable care, on an informed basis, in good faith and in the best interest of stockholders, and not second-guess the director's decisions. Only if a plaintiff proves that a director made an uninformed decision or approved a self-interested transaction will the courts apply the 'entire fairness' doctrine and require the director to prove that the price and the process leading to the disputed transaction were fair to the corporation and its stockholders. In addition, when reviewing certain transactions, such as the imposition of defensive measures (e.g., a poison pill) or the sale of control in the absence of a 'fully informed' disinterested shareholder vote[35] (see the *Revlon* discussion, above), Delaware courts apply what has come to be known as 'enhanced scrutiny', a standard more rigorous than the business judgement rule but less than entire fairness, in which the court reviews the adequacy of the process leading to the challenged transaction and whether the price was reasonable.

Delaware law also allows a corporation to exculpate its directors (but not officers) from monetary liability for a breach of the duty of care,[36] and to indemnify its directors and officers against claims and expenses arising out of the performance of their board duties.[37] Such exculpation and indemnification are not available, however, for any director or officer found to have breached the duty of loyalty.

A sponsor representative on the board of a Delaware corporation must also be aware of the corporate opportunity doctrine, under which a corporate officer or director must offer the

32 This section deals only with the laws of Delaware. The laws of other states may be materially different.

33 See, e.g., *Abraham v. Emerson Radio Corp* (Del Ch 2006).

34 See, e.g., *In re Loral Space and Communications Inc* (Del Ch 2008).

35 See, e.g., *Corwin v. KKR Financial Holdings LLC* (Del. Ch. 2015); *City of Miami Employees' and Sanitation Employees' Retirement Trust v. Comstock* (Del. Ch. 2016).

36 Delaware General Corporation Law, Section 102(b)(7).

37 Delaware General Corporation Law, Section 145.

corporation any business opportunity that the corporation is financially able to undertake, that is within the corporation's line of business, and with respect to which the corporation has an interest. The corporate opportunity doctrine can cause a problem for a sponsor owning or expecting to invest in a competing or similar business, but it can be disclaimed if appropriate language is included in a company's articles of incorporation.

If a Delaware corporation has preferred and common stock, its board owes its duties only to the common stockholders if there is conflict between their interests and those of the preferred stockholders.[38] If a corporation is insolvent (or in bankruptcy), then the board's fiduciary duties are owed to the corporation's creditors, not its stockholders.[39] If a financially struggling corporation is in a grey area known as the 'zone of insolvency', then its directors have a duty to maximise the enterprise value of the corporation for the benefit of all those with an interest in it.[40]

Limited liability companies

Recently, private equity firms have begun to prefer Delaware limited liability companies (LLCs) over corporations when structuring an investment. Delaware law allows sponsors and their co-investors to craft custom LLC governance provisions, including the total elimination of voting rights and fiduciary duties (other than the contractual duty of good faith and fair dealing),[41] which streamline decision-making and avoid potential personal liability of sponsor board representatives. The added flexibility of an LLC is both a benefit and a burden, as Delaware courts have consistently held that any modification to traditional corporate principles must be clearly and unambiguously stated in the LLC's operating agreement; otherwise, traditional corporate principles will apply (perhaps in unexpected ways).

Using an LLC, which is treated like a partnership for tax purposes (unless an election is filed with the Internal Revenue Service to be taxed as a corporation), eliminates corporate-level tax and thus can also be more tax-efficient for certain investors – although the reduction in the corporate-level tax rate and other changes implemented as a result of the Tax Cuts and Jobs Act passed in December of 2017 has made that benefit less certain. Non-US investors who are not US taxpayers, however, must exercise caution when investing in an LLC, as they may be obligated to file a US tax return and pay US income tax on their US effectively connected income.

III DEBT FINANCING

The huge US market for acquisition debt financing is highly sophisticated and efficient, with many experienced investors and service providers and multiple options for a private equity sponsor seeking to finance an acquisition.

No two deals are the same, and the availability of certain types of debt financing depends on market conditions, but US LBO financing structures typically fit into one of the following categories:

38 *In re Trados* (Del Ch 2013).

39 *Geyer v. Ingersoll* (Del Ch 1992).

40 *North American Catholic Educational Programming Foundation, Inc v. Gheewalla* (Del Sup Ct 2007).

41 See Ginsburg, Levin and Rocap, *Mergers, Acquisitions, and Buyouts – Transactional Analysis* (Wolters Kluwer, September 2015), Section 1602.3.

a senior and bridge loans, with the bridge loan usually backstopping a high-yield bond offering, typically used in very large deals;
b first-lien and second-lien loans, typically used in upper-middle-market deals, with the availability and pricing of second-lien debt highly dependent on market conditions;
c senior and mezzanine loans, typically used in middle-market deals;
d unitranche loans, which combine senior and mezzanine features into a single blended loan, typically used in middle-market deals; and
e senior loans only, typically only used in smaller deals or deals in which the private equity sponsor is using very little leverage.

Except for smaller deals (US$100 million or less), most lending facilities are arranged by a financial institution and then syndicated to other lenders,[42] including banks, hedge funds and special purpose entities – known as collateralised loan obligations – created to invest in these loans.

Because UK-style certain-funds debt financing is not available in the United States, the parties to an LBO – the lenders, the private equity sponsor and even the target – inevitably face market risk between execution of the acquisition agreement and closing. Those parties, particularly the sponsor, must therefore carefully manage that risk in the agreements, especially in the interplay among the debt and equity financing commitment letters and the acquisition agreement.[43]

The non-pricing terms (i.e., excluding items such as fees, interest rates and original issue discounts) of an LBO loan – such as affirmative, negative and financial covenants, collateral requirements and defaults – vary considerably from one deal to the next, based on the size of the transaction and the perceived creditworthiness of the borrower.[44] In general, however, loans for smaller deals are more similar to one another with respect to affirmative, negative and financial covenant requirements. Non-pricing terms for larger loans occupy a wide spectrum ranging from a full covenant package to 'covenant-lite' loans. In a syndicated loan, key terms, including pricing and debt structure, are typically subject to some limited changes in favour of the lenders – referred to as 'flex' – in the event that the loan cannot be syndicated in the absence of these changes (which may not include, however, additional conditions precedent to funding).

IV OUTLOOK

US private equity investors are cautiously optimistic for 2021's prospects. Recovery from the global covid-19 pandemic during 2021 seems plausible given the introduction of multiple vaccines in late 2020 and early 2021; the rise of SPACs in 2020 has created the possibility of a new avenue for deal making; and the Biden administration may usher in a 'green wave' of investments in sustainability, technology and alternative energy. The continued abundance of dry powder and strong stock market performance, despite the global and national challenges of 2020, provide some tailwinds for US private equity going into 2021. However, the covid-19

42 The 'marketing period' for a syndicated loan, during which the institution arranging the loan assembles the lending syndicate, typically runs for between three and four weeks.

43 See discussion in Section I.

44 Many middle-market and most – if not all – larger loans are rated by credit rating agencies such as S&P and Moody's.

pandemic and other uncertainties remain, including changes from the Biden administration and the prospect of increases to interest rates. On the other hand, 2020 proved that US private equity firms are resilient and creative and can thrive in changing and challenging times.

Appendix 1

ABOUT THE AUTHORS

MARTIN ABRAM

Schindler Attorneys

Martin Abram is a founding partner of Schindler Attorneys. Before establishing the firm, he spent 15 years at Wolf Theiss, where he became a partner in 2002.

Mr Abram's practice focuses on corporate, real estate and financing work, with a particular focus on corporate and real estate mergers and acquisitions, corporate reorganisations and project and real estate financing. He is also active in equity capital market transactions and commercial and residential leasing transactions. His practice is complemented by general real estate work and contracts work.

Mr Abram holds law degrees from the University of Vienna and the University of Nottingham School of Law. He is admitted to the Austrian Bar.

Mr Abram has published articles regarding corporate and energy law, has contributed to several Wolf Theiss publications, and is an author and co-editor of a book on the general meeting of Austrian stock corporations.

HÉCTOR ARANGUA L

Nader, Hayaux y Goebel, SC

Mr Arangua specialises in capital markets, structured finance, mergers and acquisitions and private equity.

He is recognised as a leading lawyer and for his outstanding expertise by *Chambers Latin America*, *IFLR1000*, *The Legal 500* and *Latin Lawyer 250*. *Chambers Latin America* ranks him as a leading lawyer for capital markets and has described him as 'one of the hardest-working lawyers in the market, who always goes the extra mile to ensure that everything is perfect', as 'incredibly technical and methodical, as well as having great business sense and a hands-on attitude', and as 'seriously skilled when it comes to negotiating'.

He is an expert in securities and regularly advises both private and public companies on issuances in the local market and abroad. He has also developed niche expertise in capital development certificates.

His structured finance practice is focused on providing advice to lenders on structuring complex bankruptcy-remote payment structures.

He regularly advises on M&A transactions and has also developed expertise in the venture capital and private equity sector, in which he has continuously advised on fund formation and on investment and divestment matters.

Mr Arangua has strong international experience. He is licensed to practise in New York and regularly advises US and other international clients on transactions in Mexico.

He obtained his LLM from the University of Michigan Law School, having graduated as a lawyer from the Autonomous Technological Institute of Mexico.

SHILADITYA BANERJEE

Shardul Amarchand Mangaldas & Co

Shiladitya Banerjee is a principal associate with the general corporate, M&A and PE practice group at the firm. He primarily works on matters pertaining to private equity, fund formation and mergers and acquisitions and has represented clients such as Softbank, Flipkart, Temasek and True North. His major deals include assisting Flipkart's investment in Aditya Birla Fashion and Retail Limited and the Nuvoco Group's acquisition of 100 per cent stake in Emami Cement Limited.

NATALIE BÄR

PwC

Natalie Bär is a German tax adviser and has a degree in business administration from the University of Mannheim. She joined PwC in 2014. She has over 14 years of national and international corporate tax law experience, including engagements in advising financial investors and private equity funds on aspects of German and international tax. Her expertise also extends to the areas of international tax structuring and cross-border reorganisations.

MARÍA LAURA BOLATTI CRISTOFARO

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María Laura Bolatti Cristofaro focuses her practice on corporate and transactional business matters with an emphasis on the negotiation and structuring of M&A deals.

She has experience providing counsel in local and cross-border M&A transactions and corporate reorganisations involving major businesses in different industries. Her area of expertise also includes advising local and international clients on contractual matters, start-ups, due diligence processes and day-to-day corporate matters.

María Laura joined Marval O'Farrell & Mairal in 2004. She graduated from the University of Buenos Aires with honours in law in 2007 and was admitted to the City of Buenos Aires Bar Association.

In 2013, she earned a Master of Laws (LLM) degree from the University of Chicago, after which she spent one year working as a foreign associate in Dechert LLP's corporate and securities team in New York.

She has also worked as assistant professor of a civil and commercial procedural law course at the University of Buenos Aires, and has participated in conferences and seminars on issues related to her expertise.

NICHOLAS BUTCHER

Maples Group

Nicholas Butcher is the Ireland office managing partner of Maples and Calder, the Maples Group's law firm. He advises on all aspects of investment funds and specialises in both hedge fund and private equity transactions. Nicholas has extensive experience of corporate, partnership and trust structures (including Japan-focused retail funds) and also advises on securities investment business law, as well as on listings on the Cayman Islands Stock Exchange and other worldwide exchanges.

Nicholas joined the Maples Group in 2004. He was previously a partner with Hammonds (now Squire Patton Boggs) in London, specialising in mergers and acquisitions, as well as public company corporate finance and, prior to that, for Speechly Bircham in London.

Nicholas has been recognised as a leading lawyer in *IFLR1000*, a rated practitioner in *The Legal 500*, and a leading practitioner in *Who's Who Legal: Private Funds*, and he has been ranked as a noted practitioner by *Chambers Global*.

EDWIN CHAN

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Edwin Chan is counsel in the corporate department, based in the firm's Hong Kong office. Edwin's practice focuses on general corporate, mergers and acquisitions and private equity transactions, advising on cross-border and domestic mergers and acquisitions, public and private acquisitions and divestments, growth capital and pre-IPO investments, co-investments, structured lending, PIPE and other private equity transactions across Asia. He has extensive experience advising financial sponsors and sovereign wealth funds on their investments, investment restructuring and exits in Asia.

He is recognised by *The Legal 500* as a recommended lawyer for private equity and Corporate (including M&A) in Hong Kong. He is admitted to practise law in Hong Kong and New York.

LORNA CHEN

Shearman & Sterling

Lorna Xin Chen is the firm's Asia regional managing partner, head of Greater China and the founder and head of the Asia investment funds practice. Lorna has 20 years' experience in the investment funds and private equity field, advising clients in the structuring, restructuring, formation and operation of alternative investment products, including private equity funds, venture capital funds, hedge funds, real estate funds, funds of funds, project funds and co-investment structures. Lorna serves as a vice chairman of the Technical Committee of Hong Kong Venture Capital and Private Equity Association. Her recent publications include the chapters on Hong Kong investment funds in the *Chambers Global Practice Guide* and *The Private Equity Review*.

FLORIAN CVAK

Schindler Attorneys

Florian Cvak is a founding partner of Schindler Attorneys. Before establishing the firm, he was a partner at Schoenherr, where he co-headed the private equity practice. His track record includes some of the largest and most prestigious Austrian transactions, including the acquisition by a consortium of France Telecom and Mid Europa of Orange Austria, and the subsequent sale to Hutchison and Telekom Austria. Private equity and hedge fund clients include Goldman Sachs (MBD), Carlyle, EQT, Bridgepoint, Mid Europa, Deutsche Private Equity, Riverside, PPF, DBAG, Findos Investors, HIG, OpCapita, VR Equitypartner, Lion Capital, Mezzanine Management, Darby, FirTree and LPC Capital.

Mr Cvak's practice focuses on corporate and corporate finance transactions in Austria and the CEE, with a particular focus on the areas of mergers and acquisitions, private equity, venture capital and LBO financings. Furthermore, he specialises in US lease and project finance transactions involving various types of utility assets. His practice is complemented by restructuring, general corporate and contracts work.

Mr Cvak holds law degrees from the University of Vienna and New York University Law School (LLM), and he has attended extracurricular classes on private equity, corporate finance, investment banking and accounting at the New York University Stern School of Business.

Mr Cvak is ranked by international legal directories such as *Chambers Global*, *Chambers Europe*, *The Legal 500*, *IFLR1000* and *Who's Who Legal*. He was named Austrian private equity lawyer of the year in the ACQ5 Law Awards for three years consecutively, and is featured in *The Best Lawyers in Austria*. As well as being included in the listings for the Austrian market, Mr Cvak is acknowledged in a special ranking by *Chambers Global* for his Polish expertise.

Mr Cvak is admitted to the Austrian and New York Bars. He regularly authors articles on private equity, M&A, corporate finance and restructuring in major international and national publications, and he is a frequent speaker at conferences and seminars on private equity and corporate and M&A matters.

CATARINA CORREIA DA SILVA

Luiz Gomes & Associados – Sociedade de Advogados SP, RL

Catarina Correia da Silva has extensive experience in M&A and private equity transactions. The main projects on which she has been advising recently include the structuring and negotiation of sale and purchase agreements, the coordination of due diligence procedures, and the negotiation of finance agreements, commercial contracts and partnerships in a wide variety of sectors, as well as the structuring of private equity transactions.

Mrs Catarina Correia da Silva provides legal advice on setting up private equity funds and distressed debt funds, and provides day-to-day assistance regarding the legal framework of private equity funds and of their management entities.

CARLOS DE CÁRDENAS

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Carlos specialises in structuring of both local and international funds, secondary transactions, carried interest arrangements, and a broad range of transactions relating to the restructuring of private equity funds, structuring of special purpose vehicles for investment into private equity and the establishing of fund managers. He also regularly acts for a number of investors investing in Spanish and international investment funds.

He has advised a large number of private equity houses and investors including Altamar Capital, Portobello Capital, Arcano Capital, Gala Capital, MCH Private Equity, Altan Capital, Atlas Capital Private Equity, as well as international institutions investing into private equity such as the European Investment Fund or the European Bank for Reconstruction and Development, and the Spanish government in relation to its investments in private equity funds.

Carlos worked for SJ Berwin from 1999 to 2008 as one of the founder members of its funds practice in the Madrid office.

VÍCTOR DOMÉNECH

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Víctor's work focuses on the provision of tax and legal advice to national and international private investment funds, corporations and their management teams, in particular in connection with the formation and operations of investment funds (buyout, venture capital, debt, real estate, energy, etc.), international tax planning, M&A, corporate finance and regulatory issues.

He has advised numerous investment funds and corporations, such as Portobello Capita, Gala Capital, MCH Private Equity, Atlas Capital, Nazca Capital, Trafalgar Funds, Credit Suisse, the European Bank for Reconstruction and Development and the Spanish government in relation to its investments in private equity funds.

Víctor worked as a senior associate in the private equity team of SJ Berwin from 1999 to 2008.

PALAK DUBEY

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Palak Dubey is an associate working in the general corporate, M&A and PE practice group at the firm. Palak primarily works on transactions involving extensive due diligence and assists with the completion process.

HOLGER EBERSBERGER

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Holger Ebersberger is a partner at Noerr PartGmbB.

SANG-YEON EOM

Shin & Kim LLC

Mr Sang-Yeon Eom is a partner in the finance team at Shin & Kim LLC. Mr Eom has extensive experience in advising clients in connection with private equity funds, capital markets, project finance, and mergers and acquisitions of financial institutions and related licences and approvals by financial regulators. Mr Eom advises domestic and global investment banks, various financial institutions and other corporations in relation to both domestic and cross-border transactions.

PHIDIAS FERRARI

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Phidias Ferrari advises Swiss and international clients on corporate and M&A transactions, whether domestic or cross-border, including private equity and venture capital transactions, public takeovers, joint ventures, business transfers, restructurings and relocations. In addition to transactional work, he assists private and listed companies, family offices, entrepreneurs and start-ups or scale-ups in dealing with a wide range of corporate, commercial, contractual and regulatory matters in a variety of industries, striving to offer comprehensive and practical legal advice.

As part of his banking and finance practice, he regularly advises banks, securities traders, asset and investment managers and fintech companies on financial market laws and regulations, including licensing requirements for setting up and conducting their business activities in or from Switzerland.

He also acts for arrangers, underwriters, lenders, borrowers and sponsors in domestic and multijurisdictional financing transactions (including acquisition, leveraged and syndicated financings).

IAN FERREIRA

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Ian Ferreira is a tax partner in the London office of Kirkland & Ellis International LLP. He advises on a wide range of UK and international tax matters; in particular, private fund structuring, real estate fund structuring, cross-border corporate and private equity M&A, and complex cross-border restructurings. Ian is listed as a 'recommended' lawyer for corporate tax in *The Legal 500: United Kingdom* 2021.

VERA FIGUEIREDO

Luiz Gomes & Associados – Sociedade de Advogados SP, RL

Vera Figueiredo has expertise in advising companies and groups in restructuring operations, both domestic and cross-border, and covering all phases from feasibility analysis to planning and implementing the operations. She also has expertise in advising clients in tax structuring their investments in Portugal, namely in real estate and other sectors.

Mrs Vera Figueiredo also has extensive experience in international tax transactions and has advised clients on inbound and outbound investments and on the internationalisation of several Portuguese groups, as well as advising multinationals investing in Portugal.

ALEJANDRA FONT

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Alejandra specialises in corporate and commercial law, providing advice to Spanish and foreign corporations in relation to M&A and private equity transactions, regulatory issues as well as legal and regulatory advice to fund managers in relation to fund formation and primary and secondary transactions.

She has advised a large number of private equity houses, investors and corporations including Arcano Capital, Nazca Capital, MCH Private Equity, Altamar Capital, Uninvest, Nmas1 Eolia, BCN Ventures, Talde Gestión, Riva & García, Valmenta, Lombard Odier Darier Hentsch Private Equity, Iberhispania Capital and Abraxa. She has also advised the Spanish government in relation to its investments in private equity funds.

Alejandra worked for SJ Berwin from 1999 to 2005, being one of the founder members of the private equity team in the Madrid office.

MANUEL GARCÍA-RIESTRA

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Manuel specialises in the establishment and structuring of closed-ended investment funds (including private equity, venture capital, debt, special situations, infrastructure and real estate funds), collective investment schemes and its ancillary corporate law implications, establishment of management entities, primary investments, co-investments and secondary market transactions.

He has advised numerous investment funds including Triton Capital, Magnum Capital, N+1, Portobello Capital, Realza Capital, Alteralia, Oquendo Capital, Galdana Ventures and Nereo Green Capital as well as various investors in primary investments, co-investments and secondaries transactions including Altamar Capital, Galdana Ventures, Fonditel, BBVA, Bankia, BCEISS, ABANCA, Headway Capital, SL Capital and the European Investment Fund.

Manuel was a member of the international funds team of SJ Berwin between 2005 and 2015. During this period he was seconded for one year to its London office to assist in the fundraising of Triton Capital IV and in several co-investments and secondaries transactions.

HANS P GOEBEL C

Nader, Hayaux y Goebel, SC

Mr Goebel is a Mexican lawyer specialising in mergers and acquisitions, private equity, capital markets, and banking and finance.

He is recognised as a leading lawyer and for his outstanding expertise by *Chambers Latin America*, *IFLR1000*, *Best Lawyers* and *PLC Which lawyer? Chambers Latin America* ranks him as a leading individual for capital markets, describing him as a 'tremendous negotiator', and also notes that 'he is a very good and innovative lawyer who offers strong capabilities in financing matters'. Other recent editorial commentary in this publication includes feedback from clients who point out that Mr Goebel is 'a terrific lawyer who is always on top of everything and can resolve anything you ask of him', and they highlight his 'rare skill in being able to capture what is important, and being truly practical in making it happen'.

Mr Goebel spent a year working in the Chicago office of international law firm Mayer Brown, having received his LLM (with honours) from the Northwestern University Pritzker School of Law of Chicago. He graduated as an attorney from the Autonomous Technological Institute of Mexico and has lectured in financial contracts at the Ibero-American University. He has acted as an independent director and board secretary for various financial and non-financial institutions.

ANDRÉ LUIZ GOMES

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André Luiz Gomes has extensive experience in corporate finance, capital markets and M&A.

In recent years, he has advised public and private institutions on the acquisition of companies, on capital markets (public offerings and takeovers), and on the structuring of private equity transactions. He has advised clients on matters in a variety of different sectors (particularly banking and financial intermediation services), as well as in the private equity sector, notably in relation to restructuring funds and transactions of companies in this context.

He has also been deeply involved in bank recapitalisation transactions (in the context of the recapitalisation of the Portuguese banking system).

Mr André Luiz Gomes is recommended by several leading legal directories, including *Chambers Global*, *Chambers Europe* and *PLC Which lawyer?*, for his work in corporate and M&A, capital markets and private equity.

MIGUEL Á GONZÁLEZ J

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Mr González specialises in banking and finance, structured finance, mergers and acquisitions and private equity.

He has experience in advising public and private companies on issuances in the local market and abroad, and in advising foreign companies, investment funds, banks and brokerage firms on matters primarily related to banking and securities law, capital markets, private equity investment structures, and compliance and supervision of the Mexican securities market.

Mr González graduated as an attorney-at-law (2009) from the Panamerican University, from which he also holds a graduate degree in commercial and corporate law, with honours (2010), and he obtained his LLM in finance from the Institute for Law and Finance of the Goethe University Frankfurt am Main (2013); he is a candidate for an MBA at the Monterrey Institute of Technology and Higher Education.

MARCO GRAZIANI

Legance – Avvocati Associati

Marco Graziani is a tax lawyer with extensive experience in all areas of taxation. He is actively involved in the structuring of sophisticated M&A, private equity, financing, restructuring and real estate deals, as well as in the designing of complex financial instruments. He regularly supports domestic and international clients in the establishment of European and Italian fund structures and in dealing with all related issues, from the setting-up of managing and advisory entities to the structuring of efficient carried interest schemes, and he assists several non-Italian institutional investors and sovereign funds in optimising their Italian investment structures. He has a successful track record in efficiently managing relationships with the tax authorities, as well as in the context of the fund industry, from negotiating rulings and advance pricing agreements to representing clients in tax audits, settlements and appeals.

EKTA GUPTA

Shardul Amarchand Mangaldas & Co

Ekta Gupta is an M&A and PE partner at the firm and has advised multiple blue-chip private equity funds, public and private companies, sovereign wealth funds, multinational corporations, strategic corporate clients and Indian conglomerates on a wide variety of their complex cross-border PE and M&A transactions. Ekta's diverse practice includes representing clients in acquisitions, disposals, minority and strategic investments, and advising on strategic joint ventures. In 2017, she was recognised as the 11th most hardworking corporate lawyer in Asia by Mergermarket based on the number of deals she closed in 2017, in terms of volume. In 2018, she was shortlisted as a Rising Star in Asia for corporate matters in the Euromoney Legal Media Group Asia Women in Business Law Awards 2018.

Ekta's notable transactions include advising Walmart in relation to its investment by Walmart International Holdings, Inc and Walmart Inc in acquiring a 77 per cent stake in Flipkart Pvt Ltd for an aggregate consideration of US$16 billion. In another transaction, she advised One97 Communications Limited (Paytm) in relation to a multi-staged investment of US$680 million by Alipay Singapore E-Commerce Private Limited and Alibaba Inc., which won Deal of the Year at the IFLR Asia Awards 2015.

She has also advised Blackstone in relation to the 100 per cent buyout of two seaplane operating companies in the Maldives, which was nominated for the private equity Deal of the Year at the IFLR Asia Awards 2014.

JONATHAN HALWAGI

Fasken Martineau DuMoulin LLP

Jonathan Halwagi provides counsel in the areas of asset management and investment funds. His practice focuses on the establishment of fund structures with an emphasis on alternative asset management (including private equity, venture capital, infrastructure and lending). He also regularly acts for Canadian and international asset managers, assisting them with their compliance with applicable Canadian securities laws and regulations.

Jonathan assists asset managers in their dealings with Canadian regulators and counsels them on acquisitions, joint ventures and mergers.

Before joining Fasken, Jonathan practised with a leading UK law firm in its investment funds group.

PETER HAMMERICH

BAHR

Peter Hammerich is a partner at BAHR law firm, and head of BAHR's asset management and private equity group. Having practised within asset management, investment funds and private equity for more than 22 years (14 as a partner), Mr Hammerich represents hedge funds, private equity funds, open-ended investment companies and other asset management vehicles, as well as their sponsors, managers, service providers, portfolio companies and institutional investors. Mr Hammerich serves in various capacities in the Norwegian Venture Capital & Private Equity Association and is a board member of several leading Norwegian asset managers. He is the author of several publications within his field of expertise.

MELANIE B HARMON

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Melanie Harmon is a corporate partner in the firm's Chicago office. Her practice primarily involves advising private equity funds and their portfolio companies in mergers and acquisitions, divestitures, joint ventures and other complex corporate matters.

Melanie received her BA, *magna cum laude*, in 2010 from Northwestern University. She received a JD with honours in 2013 from The University of Chicago Law School, where she was the executive editor of *The University of Chicago Legal Forum*.

MARKUS HEISTAD

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Markus Heistad is a senior lawyer in BAHR's asset management practice group, having practised within asset management for more than 10 years. Before joining BAHR, Mr Heistad held a position with the financial markets department of the Norwegian Ministry of Finance, working with financial services regulation. Mr Heistad's practice focuses on asset management, banking and insurance regulation, as well as transactions within those fields.

TOM HENDERSON

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Tom Henderson is a New Zealand-qualified foreign attorney in Shin & Kim LLC's corporate and M&A practice group. Tom holds a Bachelor of Laws (honours) and Bachelor of Arts from the University of Auckland, and assists international and Korea-based clients on large-scale, cross-border mergers and acquisitions, and general commercial matters.

TRACY HOOEY

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Tracy Hooey is vice chair of Fasken's business law practice in Ontario. Her practice is focused on securities and mergers and acquisitions. She advises public and private clients on a range of transactional matters, including securities offerings, acquisitions and divestitures, investment product structuring and corporate governance and securities law compliance matters.

Tracy also works extensively with participants in the investment product and wealth management industries. She advises clients on fund formation matters, including the structuring of public retail funds, private equity and venture capital funds, pooled funds and structured limited partnership vehicles created for special purpose acquisitions or alternative asset classes. As a result of her securities regulatory experience, Tracy is regularly engaged in transaction work in the investment product and wealth management industries, fund governance and registrant compliance matters, including for new entrants in the fintech space that require assistance navigating the securities regulatory compliance requirements.

MIKITO ISHIDA

Mori Hamada & Matsumoto

Mikito Ishida is a partner at Mori Hamada & Matsumoto. He has varied experience in advising in the formation of global and domestic private equity and venture capital funds, leveraging on his deep knowledge of fund regulation and fund structuring. His practice also includes supporting investments in Japanese and foreign start-ups, both from the investor side and the issuer side. He also practises in cross-border M&A transactions and M&A disputes, as well as in general corporate matters. He earned a bachelor's degree in economics from the University of Tokyo in 1996 and a JD, *magna cum laude*, from the University of Tokyo School of Law in 2009. He also earned an LLM from Stanford Law School in 2015, where he received the Gerald Gunther Prize for Outstanding Performance in Venture Capital. He was admitted to practise in Japan in 2010 and New York in 2016. Before joining Mori Hamada & Matsumoto, he worked for a venture capital firm as an investment officer for four years, and engaged in investment in a variety of start-ups as well as in fund administration works.

ROBERT KORNDÖRFER

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Robert Korndörfer is an associated partner at Noerr PartGmbB.

DIEGO S KRISCHCAUTZKY

Marval O'Farrell & Mairal

Diego Krischcautzky joined Marval O'Farrell & Mairal in 1997 and has been a partner at the firm since 2006. His practice is focused on business law, with particular emphasis on M&A.

He has extensive experience in M&A transactions, structuring and financing of private equity investments and counselling and structuring of local and international investments. He works regularly with companies and investment funds.

Both *Chambers Global* and *Chambers Latin America* have recently recognised him as a leading lawyer in Argentina for private equity and corporate/M&A. In addition, the *International Financial Law Review* and *Latin Lawyer* have listed him as a recommended lawyer for M&A and private equity.

Prior to joining Marval, he was an associate at Arthur Andersen – Norte Sabino Asesores Legales (1995 to 1997). He graduated with honours in law from the University of Buenos Aires in 1995, and completed a Master of Laws and Economics at the Torcuato Di Tella University in 2000–2001.

He contributes regularly to local and international publications in his areas of expertise and is a member of the City of Buenos Aires Bar Association.

VOLKER LAND

Noerr PartGmbB

Dr Volker Land is a partner at Noerr PartGmbB.

AISHA P LAVINIER

Kirkland & Ellis LLP

Aisha Lavinier is a corporate M&A partner in the firm's Chicago office. She advises private equity sponsors and their portfolio companies as well as public companies on complex business transactions, including mergers and acquisitions, divestitures, de-SPAC transactions, joint ventures, recapitalisations and other general corporate matters.

Aisha received her JD, *cum laude*, in 2013 from Northwestern University's Pritzker School of Law, where she was the Editor-in-Chief of the *Journal of Technology and Intellectual Property*. She received her BA in Biochemistry and Cell Biology in 2007 from Rice University.

TONG-GUN LEE

Shin & Kim LLC

Mr Tong-Gun Lee is a partner at Shin & Kim LLC. Mr Lee's practice focuses on inbound and outbound M&As, joint ventures and private equity transactions. He has been a major player in some of the most notable M&A transactions over the years and has also advised on high-profile hostile takeover litigation and disputes. His vast experience in friendly and hostile M&A transactions and disputes has earned him a reputation as a top-notch, go-to M&A attorney for sophisticated documentation and brilliant negotiation.

He has been distinguished as a leading corporate/M&A lawyer by *Chambers*, *Asialaw Profiles*, *The Legal 500* and *Legal Times*.

He has acted for reputable private equity houses, including IMM, H&Q, Mirae Asset PE and Skylake, as well as strategic investors such as SK Group, Lotte Group, Hanwha Group, OCI, FILA and Novelis.

Mr Lee has also authored numerous articles concerning M&A for international publications and lectured at the Judicial Research & Training Institute and Seoul National University.

JEREMY LEGGATE

Kirkland & Ellis International LLP

Jeremy Leggate is an investment funds partner in the London office of Kirkland & Ellis International LLP. Jeremy advises and represents private investment fund sponsors with respect to all aspects of the structuring and operation of alternative investment funds, focusing on a variety of strategies across various asset classes, in addition to the carried interest and co-investment plans associated with such funds. Jeremy also advises on a broad range of other transactions relating to private investment funds, including fund restructurings, co-investment arrangements and management company transactions.

XIAOXI LIN

Xiaoxi Lin was a partner in Kirkland & Ellis International LLP's Hong Kong office. He moved to Linklaters in March 2021. He focuses his practice on mergers and acquisitions, in which he represents public and private companies, as well as private equity firms, in a variety of complex cross-border transactions, including take-private transactions, leveraged buyouts, PIPEs, equity investments and joint ventures.

IAIN MCMURDO

Maples Group

Iain McMurdo is a partner in the funds and investment management team and global head of private equity at Maples and Calder, the Maples Group's law firm, specialising in the formation of private equity funds and advising on their resulting downstream transactions. He also works extensively with hedge fund managers and their onshore counsel, advising on the structuring and ongoing maintenance of hedge funds. Iain represents large financial institutions and investment managers, including well-known sponsors of private equity and hedge funds, as well as boutique and start-up investment managers. Iain joined the Maples Group in 2008. He was previously a partner at an international law firm in the Cayman Islands and, prior to that, worked for Freshfields in London, specialising in takeovers and mergers.

Who's Who Legal has ranked Iain as one of the most highly regarded individual offshore lawyers in private funds and he was recognised as *Who's Who Legal*'s 2015 lawyer of the year (private funds). Iain has been featured in *Latin Lawyer 250*, recognised as a leading lawyer in *The Legal 500* and *IFLR1000*, and in Legal Media Group's *Expert Guides*. He has also been ranked in Band 1 as a notable practitioner by *Chambers Global*.

ELLEN MAO

Paul, Weiss, Rifkind, Wharton & Garrison LLP

Ellen Mao is counsel in the corporate department, based in the firm's Hong Kong office. Ellen's practice focuses on complex cross-border financing, acquisition financing, project financing and corporate finance. She has extensive experience advising financial institutions, China and international corporates, funds and government agencies on their complex cross-border financing and restructuring matters in Hong Kong, China and India.

Ellen is recognised by legal directories as a key lawyer for banking and finance in Hong Kong. She is admitted to practise law in China (not practising), New York, and England and Wales.

FRANK MAUSEN

Allen & Overy

Frank Mausen specialises in securities law and capital markets regulation, including stock exchange listings. His clients include fund and asset managers, banks as well as corporate, institutional, supranational and sovereign issuers, which he advises on debt and equity transactions and structured finance transactions, including securitisation, structured products, covered bonds, IPOs, placements and buy-backs of securities, exchange offers, listing applications and ongoing obligations deriving from such listings.

Frank regularly holds conferences on securitisation and other capital markets topics in Luxembourg and abroad. He is a member of the securitisation working group of the Association of the Luxembourg Fund Industry and the securitisation working group and the Securities Committee of the Luxembourg Bankers' Association. Frank is also a member of the Islamic Finance working group of Luxembourg for Finance (Luxembourg's agency for the development of the Luxembourg financial centre) and is a member of the securitisation working group of the HCPF (an advisory committee set up by the Luxembourg Ministry of Finance, aiming to modernise Luxembourg's financial sector legislation).

RAGHUBIR MENON

Shardul Amarchand Mangaldas & Co

Raghubir Menon is the regional practice head of the M&A, private equity and general corporate practice at the firm. He is an expert on matters pertaining to private equity, joint ventures, and mergers and acquisitions. Raghubir has advised many private equity and sovereign wealth funds across the full range of their operations and activities and regularly advises funds such as Blackstone, Softbank, KKR, Baring Private Equity, General Atlantic, Temasek, GIC and CPPIB. He represents investment and commercial banks, private equity funds, multilateral agencies and strategic corporate clients on a variety of domestic and cross-border transactions.

Raghubir won the M&A Lawyer of the Year: Private Equity for Asia Pacific at the Asian Lawyer Emerging Markets Awards 2015 for the work undertaken over 2015. As 'one of the few lawyers that has the combination of both commercial and legal skills', Raghubir Menon enjoys a formidable reputation in the private equity market. 'He would always be available and meet the deadlines without compromising on quality. We were more than impressed,' explains one client, as quoted by *Chambers*.

Prior to joining Shardul Amarchand Mangaldas, Raghubir worked with White & Case LLP, in London and Singapore, for five years. Raghubir has an LLB from the prestigious National Law School of India University, Bangalore. He enrolled at the Bar Council of Delhi in 2004 and is a qualified solicitor (England and Wales).

PATRICK MISCHO

Allen & Overy

Patrick Mischo is the senior partner at Allen & Overy in Luxembourg. He specialises in international and corporate tax law and advises clients on the tax aspects of domestic and international private equity, real estate and debt transactions and investments, and on the structuring of Luxembourg regulated and unregulated alternative investment funds. He also has extensive experience in securitisations, structured finance and capital markets.

Patrick regularly speaks about and publishes articles on tax topics. He is a member of the Tax Committee of Invest Europe, of the board of the Luxembourg Private Equity Association and of the Tax Steering Committee within the Association of the Luxembourg Fund Industry.

PREM MOHAN

Kirkland & Ellis International LLP

Prem Mohan is a partner in the London office of Kirkland & Ellis International LLP. Prem advises private investment fund sponsors on the regulatory issues relating to the structuring and formation of private investment funds across a variety of asset classes, as well as co-investment arrangements, fund restructurings, liquidity solutions, secondary transactions and strategic minority investments in private investment firms. He also advises financial investor clients on the regulatory issues relating to acquisitions, restructurings and exits involving investments in the financial services sector.

MIGUEL LENCASTRE MONTEIRO

Cuatrecasas

Miguel Lencastre Monteiro has been an associate in Cuatrecasas' corporate and commercial practice since 2018. He obtained his Bachelor of Laws from the Catholic University of Portugal in Porto (2015) and completed the curricular part of a master's degree in law and management at Nova University Lisbon. He has been a member of the Portuguese Bar Association since 2018.

His practice is focused on cross-border M&A in Portugal, joint ventures and private equity transactions, having been involved in major transactions within renewable energy (especially in hydroelectric, wind and solar power plants) and infrastructure sectors.

ANIL MOTWANI

Shearman & Sterling

Anil Motwani is an associate who represents fund sponsors in all major asset classes and is regularly involved in the design and development of alternative investment products and services, and the structuring and restructuring of private equity funds. He also advises private equity fund sponsors and investors on ongoing operational matters. Anil has extensive experience representing limited partners and general partners in their fund transactions. Anil is a member of the Hong Kong Venture Capital and Private Equity Association. He is a co-author of chapters on Hong Kong investment funds in the *Chambers Global Practice Guide* and *The Private Equity Review*.

VAÏK MÜLLER

Tavernier Tschanz

Vaïk Müller's main areas of focus are banking and finance, financial services and products, including funds and derivatives, as well as compliance and regulatory matters. He has a broad experience in advising Swiss and international financial institutions, such as funds, asset managers, banks and securities dealers or brokers on local and cross-border issues.

He is also regularly involved in corporate, commercial and financing transactions, acting for arrangers, underwriters, lenders, borrowers and sponsors in domestic and multijurisdictional financing transactions (including acquisition, leveraged and syndicated financings).

PETER MYNERS

Allen & Overy

Peter Myners is the co-head of Allen & Overy's global alternative investment initiative. His practice consists of a wide range of corporate matters, and he has notable expertise in mergers and acquisitions (both domestic and cross-border) and joint ventures and co-investments. In particular, Peter has extensive experience in advising global alternative investment managers on the establishment and ongoing operation of their Luxembourg investment platforms, as well as on the deals they execute from those platforms.

Peter is a member of the Executive Committee of the Luxembourg Private Equity and Venture Capital Association, and a regular speaker at seminars in Luxembourg and the surrounding area on a broad range of topics, including on trends in the alternative investments space, M&A trends, recent developments in Luxembourg corporate law and directors' duties under Luxembourg law.

FELIX VON DER PLANITZ

PwC

Felix von der Planitz is a certified German lawyer and tax adviser. He joined PwC Germany in August 2001. He has headed the German private equity fund group since July 2012. Mr von der Planitz and his team advise single fund and fund-of-funds clients around the world on fund formation, fund reorganisation, tax compliance and regulatory topics.

ANABEL QUESSY

Fasken Martineau DuMoulin LLP

Anabel Quessy's corporate law practice focuses on serving the investment management industry. As part of the investment management practice team, Anabel regularly counsels asset and fund managers in connection with compliance with applicable securities laws and regulations and assists them in setting up new investment funds, including alternative asset management structures (notably private equity, venture capital, infrastructure and lending).

Anabel also accompanies clients through mergers and acquisitions of investment management businesses, helping clients at all stages of the process, from the initial deal structuring to the post-closing integration of assets.

Anabel also advises institutional investors on corporate issues and the governing regulatory framework.

RYAN RABINOVITCH

Fasken Martineau DuMoulin LLP

Ryan Rabinovitch is a partner in Fasken's tax group. Ryan's practice deals with all aspects of tax law, with a particular focus on tax planning and tax litigation.

Over the years, Ryan has held a variety of positions in the legal profession, from which he has gained broad expertise. He worked as a comparative law clerk for Aharon Barak, the then President of the Supreme Court of Israel, and served as law clerk to the Honourable Louise Arbour, then a justice of the Supreme Court of Canada.

Before joining Fasken, Ryan practised with an international law firm.

MARIANA NORTON DOS REIS

Cuatrecasas

Mariana Norton dos Reis has been a partner in Cuatrecasas' corporate M&A group since 2010. She worked at the Madrid office from 2004 to 2017 and is currently based in the Lisbon office, where she started her career in 1998.

Her practice, both in Portuguese and Spanish law, is focused on cross-border M&A, joint ventures, private equity transactions and restructurings, and she has extensive experience in renewable energy and infrastructures. She regularly acts for private equity investors on their investments and divestments, and represents strategic investors in connection with cross-border acquisitions and sales of privately owned companies and assets.

Mariana obtained her Bachelor of Laws from the University of Lisbon School of Law (1997) and her Master of Laws (LLM) in advanced corporate law and securities from Columbia Law School, New York (1998).

She is a member of the Portuguese Bar Association and the Madrid Bar Association and was admitted to the New York State Bar Association.

Mariana is also the founder and coordinator of the Women in Business programme at Cuatrecasas and secretary of the Women's Interest Group at the IBA.

STEPHEN L RITCHIE

Kirkland & Ellis LLP

Stephen L Ritchie is a partner in the Chicago office of Kirkland & Ellis. His practice is concentrated in the areas of complex business transactions, with a particular focus on structuring, negotiating and managing the legal aspects of mergers, acquisitions, leveraged buyouts, recapitalisations, venture capital and growth equity investments, restructurings and workouts. He has also served as lead counsel in the representation of numerous portfolio companies of private equity funds.

Praised by clients for achieving 'remarkable results on divestitures' and by peers as 'one of those great lawyers who is easy to work with', Mr Ritchie has been recognised by *Chambers USA: America's Leading Lawyers for Business* in the areas of corporate law, M&A and private equity every year from 2006 to 2019. He was also named *Best Lawyers*' 2013 Chicago leveraged buyouts and private equity law Lawyer of the Year. He has also been listed in *The Best Lawyers in America* every year from 2007 to 2019, and as one of Illinois' Super Lawyers every year from 2005 to 2006, and 2008 to 2019. He has been recognised by *The Legal 500: United States*, from 2012 to 2020, for his work in private equity buyouts.

Mr Ritchie has handled many private equity, LBO, venture capital and M&A transactions for GTCR, TCV, CHS Capital, Chicago Growth Partners, Evergreen Pacific Partners, William Blair Capital Partners, Wind Point Partners, the Ontario Teachers' Pension Plan Board, Solera Holdings, Inc, and others.

He is a lecturer at the University of Chicago Law School, teaching 'Private Equity Transactions: Issues and Documentation' (from 2011 to the present), and is a member of the American Bar Association.

BRANDON RYU

Shin & Kim LLC

Myong-Hyon (Brandon) Ryu's practice focuses on mergers and acquisitions with a particular emphasis on cross-border (both inbound and outbound) transactions. He also has extensive experience in private equity transactions, joint ventures, corporate restructurings and corporate governance. Mr Ryu has represented both major Korean and foreign industrial and financial companies, as well as private equity firms.

Mr Ryu devotes a portion of his practice to advising clients in anti-corruption (including anti-corruption due diligence in M&A transactions), Foreign Corrupt Practices Act-related and internal investigations, transnational white-collar crime defences and other compliance matters.

Mr Ryu has been distinguished as a leading corporate/M&A lawyer by *Chambers Global*, *Chambers Asia-Pacific*, *The Legal 500*, *IFLR1000*, *Asialaw Profiles* and *PLC Which lawyer?* He was commended in *The Legal 500: Asia Pacific* for 'always trying to find the right solutions and exceed clients' expectations in all respects'. He is also described by *Chambers Asia-Pacific* as 'a very bright and pragmatic team leader who is involved in many of the firm's most prominent recent deals' and someone who 'understands the corporate world very well and tries to make things as straightforward as possible'. He is a regular contributor to various international journals, as well as a speaker at international and domestic conferences covering the areas of his expertise. He has been interviewed and quoted by newspapers and magazines for his knowledge and expertise in M&A.

Mr Ryu received a JD from Vanderbilt University Law School in 2001 and a BA, *magna cum laude*, from Sogang University in 1998. He is a member of the New York Bar.

Mr Ryu has co-authored articles for international publications, including *International Financial Law Review* and *Asian Counsel*. He has also lectured at the Judicial Research & Training Institute, Sungkyunkwan University and Konkuk University.

ENZO SCHIAVELLO

Legance – Avvocati Associati

Enzo Schiavello has a solid background in M&A and corporate law. For more than 20 years, he has been active in the structuring and establishment of alternative investment schemes for domestic and international clients, with particular emphasis on private equity and real estate funds. His expertise ranges from the formation and restructuring of licensed investment managers to the setting up of corporate and contractual structures in Italy and other EU jurisdictions, including funds of funds, co-investment funds, infrastructure funds, non-performing loan funds, SICAFs, structured products providing exposure to private equity as an underlying asset class, and various arrangements for the distribution of carried interest among managers. He also assists clients with respect to fund restructurings and other general partner-led transactions.

CLEMENS PHILIPP SCHINDLER

Schindler Attorneys

Clemens Philipp Schindler is a founding partner of Schindler Attorneys. Before establishing the firm, he spent six years as a partner at Wolf Theiss after practising with Haarmann Hemmelrath in Munich and Vienna, and with Wachtell Lipton Rosen & Katz in New York. His track record includes some of the largest and most prestigious Austrian and Austria-related transactions, such as the initial investment of América Móvil into Telekom Austria or Infineon's sale of its wireless business to Intel, as well as many private equity deals for international funds such as ARES, ARDIAN, Apax, DBAG, EQT, HIG, Internos, Kennet, Melrose, MDP, OpCapita, Riverside, Sankaty, Triton and TVM Capital.

Mr Schindler's practice focuses on corporate and tax law advice in relation to public and private M&A, private equity and corporate reorganisations (including mergers, spin-offs and migrations), most of which have a cross-border element. Furthermore, Clemens is specialised in international holding structures. His practice is complemented by private client work (e.g., as counsel to families owning stakes in large companies).

Mr Schindler is ranked by leading international legal directories, including *Chambers Global*, *Chambers Europe*, *The Legal 500*, *IFLR1000* and *Who's Who Legal*. The German legal directory *JUVE* singles him out as one of Austria's top 20 corporate and M&A lawyers, while the Austrian business journal *Trend* named him among the country's top 10 corporate law experts. In addition to the listings for the Austrian market, both *Chambers Global* and *Chambers Europe* acknowledge his Brazilian expertise in a special ranking.

Mr Schindler is admitted in Austria both as an attorney-at-law and a certified public tax adviser, holding law degrees from the University of Vienna and New York University (LLM in international taxation) as well as a degree in business administration from the Vienna University of Economics and Business Administration. He has authored and co-authored more than 50 articles, books and commentaries in his fields of expertise, where he is also a much sought-after speaker at conferences and seminars.

TAE-YONG SEO

Shin & Kim LLC

Mr Tae-Yong Seo is a partner at Shin & Kim LLC. Mr Seo's main areas of practice include international and domestic securities offerings, mergers and acquisitions of financial institutions, corporate restructuring and general corporate transactions. Mr Seo also worked previously as a foreign associate in the Hong Kong office of Simpson Thacher & Bartlett LLP and has experience in capital market transactions.

DONG IL SHIN

Shin & Kim LLC

Mr Dong Il Shin is an associate at Shin & Kim LLC. He received his JD from Seoul National University and a BA, *summa cum laude*, from Seoul National University. Mr Shin joined Shin & Kim LLC in 2019 and specialises in M&A transactions and corporate governance.

ROHAN SINGH

Shardul Amarchand Mangaldas & Co

Rohan Singh is an associate working in the general corporate, M&A and PE practice group at the firm. His notable transactions include advising Facebook in relation to its minority investment in Jio Platforms Limited for US$5.7 billion and acting for Abu Dhabi Investment Authority in relation to its US$750 million minority investment in Reliance Retail Ventures Limited.

TARANJEET SINGH

Shardul Amarchand Mangaldas & Co

Taranjeet Singh is a principal associate with the general corporate, M&A and PE practice group at Shardul Amarchand Mangaldas & Co. He primarily works on matters pertaining to private equity, mergers and acquisitions, and portfolio investments by funds. He has advised many private equity and sovereign wealth funds across the full range of their operations and has represented clients such as Blackstone, Temasek, General Atlantic, Invus, KKR, CPPIB and Urbaser. His notable transactions include advising Blackstone in relation to the 100 per cent buyout of two seaplane operating companies in the Maldives, which was nominated for the private equity Deal of the Year at the IFLR Asia Awards 2014; advising Blackstone in relation to the acquisition of a controlling stakes in Agile Electric Supply Private Limited, and in Mphasis Limited; advising Temasek in relation to its investments in UST Global, Devyani International Limited, Zomato and Car Trade; advising General Atlantic in relation to its investment in Krishna Institute of Medical Sciences Limited; and advising KKR in relation to its investment in JB Chemicals and Pharmaceuticals Limited.

Taranjeet also successfully completed a client-secondment stint with Blackstone Group's Asia-Pacific legal and compliance team, with direct reporting to the group's general counsel for India.

JEAN-CHRISTIAN SIX

Allen & Overy

Jean-Christian Six has extensive expertise advising clients in relation to the structuring, establishment and ongoing operation of Luxembourg regulated funds (UCITS, Part II funds, SIFs and SICARs) and Luxembourg unregulated funds (limited partnerships and RAIFs) for institutional and non-institutional investors active across all asset classes, including alternative assets such as private equity, real estate, infrastructure and debt/credit. He also assists fund management companies on their licence applications and extensions, and on cross-border issues. Jean-Christian also advises clients in the context of their investor due diligence on, and negotiations with, investment funds, as well as advising funds on their transactions and regulatory issues.

Jean-Christian regularly speaks at conferences on Luxembourg fund-related topics. He is a member of the Association of the Luxembourg Fund Industry, including acting as co-chairman of its infrastructure funds working group.

CHRIS CHANG-HYUN SONG

Shin & Kim LLC

Dr Chris Chang-Hyun Song is a partner in Shin & Kim LLC's corporate/M&A group. His main areas of practice include M&A, private equity and corporate governance. As a member of leading law firms in South Korea and in the United States, Dr Song has undertaken major M&A projects in the fields of telecommunications, information technology, games, contents, platform business, logistics, banking, securities, insurance, automotive parts, energy and chemistry.

Dr Song has been distinguished as a leading corporate/M&A lawyer by *Chambers Global*, *Chambers Asia-Pacific*, *The Legal 500* and *IFLR1000*. He has represented Blackstone, Berkshire Hathaway, Bain Capital, CVC, KKR and many other reputable private equities as well as Tencent, Kakao, Naver, Netmarble and other prominent platform companies.

Dr Song received a Doctor of Juridical Science degree in corporate and financial law from the University of California, Berkeley, School of Law, and currently teaches M&A and corporate law at Yonsei University and the Seoul Bar Association. Dr Song also publishes various legal articles and periodic columns on corporate, competition and finance law, and he is an active participant in several academic societies and conferences.

SHUHEI UCHIDA

Mori Hamada & Matsumoto

Shuhei Uchida is a partner at Mori Hamada & Matsumoto. His practice ranges from advising on high-profile M&A transactions to general corporate matters and M&A-related disputes. He is well known for his expertise in corporate law based on his experience working on the draft of the amended Companies Act that became effective in May 2015, which substantially changed M&A practice in Japan through the introduction of a new structure for squeeze-outs of minority shareholders.

ADALBERTO VALADEZ H

Nader, Hayaux y Goebel, SC

Mr Valadez specialises in taxation matters and concentrates his practice on federal income tax and international tax matters, including cross-border M&A and joint ventures, inbound investments into Mexico, and the structuring and implementation of collective investment vehicles (such as private equity funds) managed by Mexican and foreign sponsors.

He is recognised as a leading lawyer and for his outstanding expertise by *Chambers Latin America*, *IFLR1000*, *Best Lawyers*, *The Legal 500* and *Latin Lawyer 250*. *Chambers Latin America* ranks him as a leading individual for tax and has described him as an 'exceptional adviser [who] enjoys solid capabilities assisting clients with tax advisory matters, particularly in the context of financial transactions', and mentions a client describing him as 'highly competent and knowledgeable; he understands the regulations and the problems clients face very well, and is very proactive in finding solutions', as having 'extraordinary willingness to work hard', and as knowing 'the financial sector very well, so it is a mix of expertise that leads us to work very well with him'.

He has solid experience in advising clients on issuances in the local securities market, particularly in the case of capital development certificates and exchange-traded funds. As part of this practice, he regularly advises multinational clients that are either making investments in Mexico or have commercial relationships with companies in Mexico.

Mr Valadez graduated with honours as an attorney from the Autonomous Technological Institute of Mexico and he also previously worked as a foreign associate in the Amsterdam, Luxembourg and Geneva offices of Loyens & Loeff.

PIERRE-YVES VUAGNIAUX

Tavernier Tschanz

Pierre-Yves Vuagniaux advises Swiss and foreign legal entities on a broad range of domestic and international taxation, such as corporate, banking, finance and real estate taxation. His expertise further covers governance, transaction structuring, business transfer, as well as advising family offices and private clients on tax matters.

He has over 20 years of experience and has advised and represented multinational and local companies, as well as wealthy individuals (UHNWI), both in negotiations with tax authorities and in tax litigation. Pierre-Yves Vuagniaux also specialises in trusts and estate law.

IRIS WANG

Shearman & Sterling

Iris Wang is an associate who works on transactions for both general partners and limited partners in Asia. She helps private equity and hedge fund sponsors in asset management and funds-related matters, and has accumulated an understanding of fund structuring and regulatory issues in relation to fund managers. Iris is a member of the Hong Kong Venture Capital and Private Equity Association. She is a co-author of chapters on Hong Kong investment funds in the *Chambers Global Practice Guide* and *The Private Equity Review*.

JAMES YONG WANG

Jingtian & Gongcheng

James Wang has over 20 years of experience in the investment funds and private equity/venture capital field. He has, together with his team, represented international and Chinese fund clients in the structuring of about 2,000 domestic and offshore PE, VC, hedge, real estate, mezzanine, film and media, energy and infrastructure funds, QFLP and R-QFLP funds, QDLP and QDIE funds, QFII and R-QFII funds, and QDII funds with total capital commitments in excess of the equivalent of US$50 billion. He also regularly represents clients in joint venture and partnership transactions, private equity/venture capital and M&A and capital markets transactions in and outside China. He has been consistently ranked as a leading lawyer in investment funds, private equity and venture capital for China by *Chambers*, *Who's Who Legal*, *The Legal 500*, *IFLR* and *Legalband*, etc. He was also named a market leader for investment funds in China by the London-based Legal Media Group's global Expert Guides for banking, finance and transactional law, from 2015 to 2020 (the only lawyer with a PRC law firm named by Expert Guides in the investment funds category in China). He is a member of the expert review committee of the QFLP and QDLP pilot programmes administered by Shanghai Financial Services Office, and also served as adviser to the committee on private equity secondary market initiatives. James is also active in private equity and venture capital investments, M&A and capital markets transactions. Prior to working for Jingtian & Gongcheng, James worked at several major international law firms in the United States and China, including Clifford Chance, Kirkland & Ellis, Greenberg Traurig and the PRC law firm of Han Kun. James is a CFA and CAIA charter holder.

MAXI WILKOWSKI

PwC

Maxi Wilkowski is a certified German lawyer. She joined PwC in 2006. Her professional focus is on regulatory and legal aspects of the financial services industry. Maxi is specialised in advising firms entering the German market on applicable regulatory licensing and notification procedures.

BETTY YAP

Paul, Weiss, Rifkind, Wharton & Garrison LLP

Managing partner of the China practice, Betty Yap is a member of the corporate department, based in the firm's office in Hong Kong. Betty's practice focuses on cross-border M&A, strategic investments, joint ventures, private equity and special situations transactions, and foreign direct investments involving Greater China. Her clients include private equity firms, multinational corporations, financial institutions, and mainland Chinese companies across a multitude of industries including financial services, energy and resources, food and beverage, retail, TMT, automotive and real estate.

Betty is recognised by *Chambers Asia-Pacific* 2021 as a 'Band 1' individual for private equity/buyouts and venture capital investment in China among international firms, describing her as a practice head who is a 'really, really good practitioner' in private equity and M&A. The 2020 Legal 500 Asia Pacific Hall of Fame highlighted Betty for her excellent achievement in private equity work in Hong Kong, meriting her recognition as a Leading Individual in this category for nine consecutive years. Asian Legal Business Hong Kong Law Awards named her as the 'Dealmaker of the Year' in 2020. *IFLR1000* 2021 ranked Betty as a 'highly regarded' lawyer for M&A and private equity in Hong Kong, and she has been described as a lawyer who 'gives real value add in transactions and is able to navigate difficult parties to come to resolution'. Betty is also recognised by *Chambers Asia-Pacific* and *The Legal 500: Asia Pacific* as a leading M&A lawyer in Hong Kong, and she was listed on *China Business Law Journal*'s annual 'A List' for her achievements in China-related legal work in 2019 and 2020.

Betty is fluent in English, Mandarin and Cantonese. She is admitted to practise law in Hong Kong and Victoria, Australia.

JULIA YU

Kirkland & Ellis International LLP

Julia Yu is a partner in Kirkland & Ellis International LLP's Hong Kong office. She focuses her practice on corporate and securities law matters, including going-private, mergers and acquisitions and private equity transactions.

Appendix 2

CONTRIBUTORS' CONTACT DETAILS

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ISBN 978-1-83862-812-3